

Capital Market Review

First Quarter, 2012

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Summary

U.S. economic conditions continue to gradually improve. Europe has, at least temporarily, pulled away from “the brink”. Emerging markets growth has slowed, but economic policy changes are being made to re-invigorate growth. At the end of the year, several fiscal stimuli are scheduled to expire which could be a headwind to 2013 growth (some estimates are a -2% headwind) These are contentious issues, and Congress will have to work together. There is significant headline risk, but we are hopeful that a short-term solution can be reached without too much drama. Once the election is over, perhaps work on a longer-term solution can begin in earnest.

Surprisingly, the stock market had its best first quarter return since 1998 -- returning 12.9%. Developed international and emerging market stocks also had strong returns. U.S. investment grade bond returns were slightly positive but other bond segments, such as emerging markets and high yield, performed much better.

It would not surprise us if the stock market were to essentially tread water for the remainder of the year. We believe large-cap stocks are more attractively valued than mid- and small-company stocks.

Economic Conditional

The U.S. economy continued its steady improvement during the first quarter of 2012. During the past six months, 1.2 million jobs have been created. While not breakout job growth, it is a significant improvement compared to the past few years. Consumer confidence and spending appear to be healthy and retail sales are increasing. Inflation, while picking up a little, is still within the Fed's target range. Interest rates are very low and will likely remain so for the foreseeable future. Housing has stabilized and remains more affordable than at any time on record. Corporations are highly profitable and have seen incredibly strong earnings growth during the past few years. Going forward, we expect corporate profit growth to be more difficult and slow. Rising sales, as opposed to cutting costs, will be the key factor in future corporate profit growth. While we are grateful for improving U.S. economic conditions, the recovery's strength is clearly below average, particularly given the depth of the recession that occurred. Consensus estimates are for 2012 economic growth to be around 2.5%

There are also significant concerns. Spikes in gas prices act like a direct tax on consumers. Consumer spending will be impacted if gas prices remain elevated for a period of time. Europe seems to have "bought some time" in order to improve its financial condition. However, the market will demand that progress be made on getting its fiscal house in order and providing a foundation for future growth. Given austere budgets and cuts in spending, it is hard to expect any meaningful growth out of Europe for the foreseeable future. Additional uncertainty may enter the market as a few European leaders are facing re-election. In addition, several large emerging market economies are experiencing slowing economic growth and are now implementing more growth-oriented policies (their positive fiscal situations allow this). It is interesting to note that, when compared to last year, the U.S. is the only major economy expecting higher 2012 economic growth.

Here at home, we are only starting to hear more about the various fiscal policy changes that occur at the end of the year. Specifically, since the congressional "super committee" failed to meet its target, spending is to be automatically cut by \$110 billion per year starting in 2013. In addition, the Bush tax cuts are scheduled to expire along with the payroll tax cut. The estimated cumulative effect is to reduce economic growth by around 2% (assuming no changes are made). We can only hope that our political leaders will actually lead and take a bi-partisan approach that will require a combination of spending cuts and revenue increases. We

favor significantly more spending cuts, but we are also political realists and understand that revenue increases are probably a pre-condition to any type of deal. We expect a short-term, bi-partisan solution to be reached (hopefully without all of the drama that occurred during last summer's debt debate). We see little chance of a longer-term solution being agreed to during an election year. We do see significant risk in this issue and it may increase volatility. On the bright side, should one party win a mandate in November, the chances of achieving a longer-term fiscal solution in 2013 would improve.

Stock Market

The market moves in mysterious ways. The stock market reacted favorably to Europe pulling away from "the brink" and improving economic news from the U.S. In fact, the U.S. stock market return of 12.9% was its best first quarter return since 1998. As comparison, developed international markets returned 10.9% and the emerging markets returned 13.6%. During the past year, U.S. markets have significantly outperformed both developed international and emerging markets. (7.2% vs. -5.8% and -11.1%)

There was essentially no difference in U.S. company size returns as large, mid, and small company stocks returned 12.9%, 12.9%, and 12.4%, respectively. During the trailing one-year period, large stocks returned 7.9%, mid-cap stocks returned 3.3%, and small-company stocks returned -0.2%.

Growth stocks continued to outperform value stocks. During the first quarter, growth stocks returned 14.6% vs. the value stock return of 11.2%. For the trailing year, growth has outperformed value by nearly six percentage points (10.1% vs. 4.3%).

There was wide dispersion in sector returns during the first quarter. Finance, Technology, and Consumer Discretionary were the best performing sectors with returns of 22.0%, 21.5%, and 16.0%, respectively. Utilities, Telecommunications, and Energy were the worst performing sectors returning -1.6%, 2.1%, and 3.9%, respectively.

Based on existing stock market fundamentals, it appears that emerging markets currently have attractive valuations and similar or better forecast earnings growth compared to the U.S. and the developed international markets. While developed international valuation metrics are low, their growth prospects appear to be poor.

As a result of the strong first quarter return, U.S. stocks look to be in the "low-end" of fair value. There may still

be some upside potential, but we believe it will be the result of multiple expansion as opposed to unexpected strong earnings growth. Should current earnings growth expectations occur (9.4% and 13.0% for large-cap stocks in 2012 and 2013), the market may be slightly undervalued. However, we would not be surprised to see the market “tread water” from its current levels for the remainder of the year (considering a 12% return for the year pretty good). Of course, exogenous events and political uncertainty could result in significant volatility.

Based on our fair value return estimates, we believe large-cap stocks offer better return potential than mid- and small-company stocks.

Bond Market

In response to stronger economic conditions in the U.S., interest rates rose during the first quarter. While the rise in interest rates was across the entire maturity spectrum, it was most pronounced within the intermediate and longer-maturity bonds.

With that said, interest rates remain incredibly low by historical standards and the FED has given no indication that they plan on any policy changes. We do expect the yield curve to steepen as the FED maintains short-term rates at current levels and the market may force yields on intermediate and longer-maturity bonds higher. While no one wants to pay higher interest rates, this would be a positive sign that the markets are beginning to function with a lower amount of government intervention.

Inflation-adjusted yields remain negative for most maturities. In other words, in terms of purchasing power, most Treasury bond investors are losing money -- they will not be able to purchase the same amount of milk and eggs when their bonds mature as they can today. That, of course, is not a healthy condition and will eventually (but not for the foreseeable future) correct itself.

During the first quarter, the U.S. bond market returned 0.3%, ahead of the developed international bond return of -0.7%, but lagging the emerging market return of 4.2%. High yield bonds were the best performing bond segment returning 5.3%. The municipal bond return of 1.7% outperformed taxable bonds.

In terms of maturity, longer-term bonds underperformed while short- and intermediate-term bonds had similar results. Corporate investment grade bonds returned 2.0%, ahead of the mortgage-backed bond return of 0.6% and the government bond return of -1.1%.

While yield spreads between lower-quality and higher quality bonds have narrowed, we believe there is still value in having allocations to non-investment grade debt. Quality spreads are near a historical average and economic conditions in the U.S. appear to be improving. In an attempt to improve bond returns, we have made investments to high-yield and medium quality bonds.

Stock Returns For Periods Ending March 31, 2012

	<u>Qtr</u>	<u>Ytd</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>		<u>Qtr</u>	<u>1 Year</u>	<u>3 Year</u>
<u>Nationality</u>						<u>Developed Country</u>			
U.S. Market	12.9%	12.9%	7.2%	24.3%	2.2%	U.S.	12.9%	7.2%	24.3%
Developed Intl	10.9	10.9	-5.8	17.1	-3.5	Canada	5.8	-16.6	19.0
Emerging Market	13.6	13.6	-11.1	22.3	2.3				
<u>Size</u>						<u>Europe</u>			
Large	12.9	12.9	7.9	24.0	2.2	France	12.1	-19.4	8.1
Mid	12.9	12.9	3.3	29.1	3.0	Germany	20.5	-11.3	15.1
Small	12.4	12.4	-0.2	26.9	2.1	Italy	8.9	-30.2	0.3
Micro	18.6	18.6	1.6	32.5	1.0	United Kingdom	6.5	-3.8	17.5
<u>Approach</u>						<u>Pacific</u>			
Value	11.2	11.2	4.3	23.0	-0.7	Australia	7.5	-8.6	27.7
Core	12.9	12.9	7.2	24.3	2.2	Hong Kong	13.0	-7.3	19.9
Growth	14.6	14.6	10.1	25.5	5.0	Japan	10.2	-3.8	9.1
<u>Sector</u>						<u>Emerging Market</u>			
Cons Discretionary	16.0	16.0	17.5	34.2	5.2	China	9.9	-15.0	11.9
Cons Staples	5.5	5.5	17.3	20.8	8.3	India	19.8	-21.1	22.1
Energy	3.9	3.9	-6.9	19.0	5.0	Korea	14.4	-6.4	29.0
Finance	22.0	22.0	-1.8	23.2	-13.0	Czech Republic	9.3	-17.7	7.9
Healthcare	9.1	9.1	16.4	18.1	4.4	Hungary	22.8	-31.5	21.5
Industrials	11.3	11.3	1.7	28.9	2.5	Poland	17.5	-25.0	21.8
Technology	21.5	21.5	20.2	28.6	8.2	Russia	18.5	-20.2	27.4
Materials	11.2	11.2	-4.0	23.0	2.2	Brazil	13.0	-16.8	20.3
Telecomm	2.1	2.1	3.5	14.8	1.6	Chile	17.1	-0.8	27.4
Utilities	-1.6	-1.6	14.8	16.0	1.6	Mexico	15.4	-0.3	31.0

Stock Fundamentals As Of March 31, 2012

	<u>United States</u>		<u>Developed</u>		<u>Emerging</u>					
	<u>Current</u>	<u>1 Year Ago</u>	<u>Current</u>	<u>1 Year Ago</u>	<u>Current</u>	<u>1 Year Ago</u>				
Price/Earnings Current	15.3	16.5	12.0	14.4	10.9	14.5				
Price/Forecast Earnings	13.7	14.6	11.4	12.2	11.2	11.9				
Price/Book	2.1	2.3	1.4	1.6	1.8	2.2				
Price/Cash Flow	9.2	9.7	6.9	6.8	7.0	7.0				
Price/Sales	1.3	1.4	0.8	0.9	1.2	1.3				
Forecast LT EPS Growth	10.7	10.2	7.7	9.4	10.4	16.3				
	<u>Est. P/E Ratio</u>		<u>Est. EPS Growth</u>		<u>2012 Fair Value Returns</u>		<u>2013 Fair Value Returns</u>			
	<u>2012</u>	<u>2013</u>	<u>2012</u>	<u>2013</u>	<u>13x</u>	<u>17.5x</u>	<u>7% DR</u>	<u>13x</u>	<u>17.5x</u>	<u>7% DR</u>
Large	13.4	11.8	9.4%	13.0%	-2.7	31.0	7.0	10.8	48.1	20.9
Mid	19.8	16.2	14.5	21.7	-34.2	-11.5	-27.7	-20.0	7.7	-12.0
Small	22.5	17.6	21.1	28.1	-42.2	-22.3	-36.5	-26.0	-0.4	-18.7

Bond Returns And Characteristics For Periods Ending March 31, 2012

	<u>Returns</u>					<u>U.S. Bond Yields</u>	<u>Last</u>	<u>1 Year</u>	
	<u>Qtr</u>	<u>Ytd</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>		<u>Qtr</u>	<u>Qtr</u>	<u>Ago</u>
<u>Nationality</u>						Fed Funds	0.09%	0.07%	0.13%
U.S. Market	0.3	0.3	7.7	6.8	6.2	Prime Rate	3.25	3.25	3.25
Developed Intl	-0.7	-0.7	4.3	7.4	7.4	3 Month Treasury	.07	0.01	0.10
Emerging Market	4.2	4.2	10.9	16.2	8.3	1 Year Treasury	0.19	0.12	0.30
						3 Year Treasury	0.51	0.42	1.28
						5 Year Treasury	1.04	0.91	2.21
<u>Maturity</u>						5 Year TIP	-0.98	-0.72	0.02
Cash	0.0	0.0	0.0	0.1	1.1	10 Year Treasury	2.23	1.93	3.47
Short-Term	0.4	0.4	1.8	2.7	3.8	30 Year Treasury	3.35	2.91	4.52
Intermediate-Term	0.6	0.6	6.1	5.9	5.7	Aaa Corporate	4.04	3.79	5.16
Long-Term	-2.1	-2.1	19.9	12.8	9.0	Baa Corporate	5.03	5.18	6.06
<u>Sector</u>						Barclays Aggregate	2.82	2.86	3.45
Corporate	2.0	2.0	9.6	12.3	6.9	Barclays Credit	4.01	4.16	4.51
Government	-1.1	-1.1	7.9	4.0	6.0	Barclays Treasury	1.84	1.71	2.02
Mortgage	0.6	0.6	6.2	5.3	6.3	Barclays Mortgage	3.27	3.34	3.43
						Barclays Municipal	3.25	2.99	3.58
<u>Other</u>						Barclays High Yield	7.32	7.21	8.65
High Yield	5.3	5.3	6.5	23.9	8.1	Citi Intl Treasury	4.03	4.14	2.26
Inflation Protected	0.9	0.9	12.2	8.7	7.6	JPM Emerging	4.72	4.89	5.14
Municipal	1.7	1.7	12.1	7.7	5.4				

10-Year Sovereign Bond Yields

Spreads Versus 10-Year Treasury

<u>Developed Mkts</u>	<u>Qtr</u>	<u>Last</u>	<u>1 Year</u>		<u>Qtr</u>	<u>Last</u>	<u>1 Year</u>
		<u>Qtr</u>	<u>Ago</u>			<u>Qtr</u>	<u>Qtr</u>
United States	2.29%	1.90%	3.34%	Aaa	1.81	1.86	1.69
Canada	2.24	2.06	3.29	Baa	2.8	3.25	2.59
France	3.01	3.16	3.60	Barclays Aggregate	0.59	0.93	-0.02
Germany	1.97	1.92	3.22	Barclays Credit	1.78	2.23	1.04
Italy	4.99	7.15	4.75	Barclays Treasury	-0.39	-0.22	-1.45
United Kingdom	2.47	2.09	3.54	Barclays Mortgage	1.04	1.41	-0.04
Euro Zone	1.97	1.97	3.23	Barclays Municipal	1.02	1.06	0.11
Australia	4.39	3.86	5.43	Barclays High Yield	5.09	5.28	5.18
Hong Kong	1.50	1.27	2.44	Citi Intl Treasury	1.8	2.21	-1.21
Japan	1.03	0.98	1.19	JPM Emerging	2.49	2.96	1.67
<u>Emerging</u>				Maturity (10yr-1yr)	2.04	1.81	3.17
Brazil	3.14	11.17	6.16	Implied Inflation	2.02	1.63	2.19
China	3.18	3.54	3.94				
India	8.40	8.72	8.20				

**Commodity, Real Estate, & Currency Returns
For Periods Ending March 31, 2012**

	<u>Qtr</u>	<u>Ytd</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>
<u>Commodity</u>					
DJ UBS Commodity	0.9%	0.9%	-16.3%	9.1%	-2.8%
CRB Commodity Spot	3.2	3.2	-13.5	15.8	5.0
CRB Fat & Oils	0.6	0.6	-11.3	24.6	9.1
CRB Foodstuffs	1.2	1.2	-13.1	14.3	7.8
CRB Livestock	3.4	3.4	-4.4	25.5	6.7
CRB Metals	10.4	10.4	-14.8	25.5	3.1
CRB Raw Industrials	4.7	4.7	-13.8	16.8	3.2
CRB Textiles & Fibers	0.1	0.1	-21.3	7.5	2.9
<u>Agriculture</u>					
Coffee	-16.9%	-16.9%	-31.4%	16.5%	11.6%
Corn	10.6	10.6	17.2	19.0	13.6
Soybean	13.9	13.9	3.1	12.8	13.5
Sugar	-9.1	-9.1	-7.6	17.6	9.8
Wheat	0.7	0.7	-4.1	8.2	8.8
<u>Energy</u>					
Oil	7.7%	7.7%	3.2%	30.3%	11.9%
Unleaded Gas	19.4	19.4	9.1	24.2	7.9
<u>Metals</u>					
Aluminum	7.9%	7.9%	-14.5%	17.7%	-4.6%
Copper	12.1	12.1	-10.9	31.0	5.6
Gold	1.3	1.3	17.5	21.9	20.6
Nickel	2.3	2.3	-30.1	24.3	-16.6
Zinc	6.5	6.5	-13.1	18.5	-9.0
<u>Real Estate</u>					
MSCI U.S. Reit	10.7%	10.7%	13.0%	43.5%	-0.2%
MSCI World Reit	12.5%	12.5%	2.1%	28.9%	-5.1%
<u>Currency</u>					
	<u>U.S. Dollar Returns</u>				
Euro	-0.5%	-0.5%	5.8%	-0.4%	0.1%
Japan	6.0	6.0	1.0	-5.5	-6.8
U.K.	-1.5	-1.5	2.1	-3.7	4.1
Brazil	-2.4	-2.4	8.3	-8.1	-3.0
China	-0.6	-0.6	-3.8	-2.6	-4.0
India	-3.9	-3.9	12.1	-0.5	2.8
Mexico	-7.4	-7.4	6.3	-4.5	2.8

Summary of Current Economic & Financial Conditions

	Percent Change					Data As Of
	3 Month % Change	3 Month % Change Annualized	6 Month % Change	6 Month % Change Annualized	1 Year % Change	
	Gross Domestic Product	0.73	2.95	1.18	2.38	
Leading Economic Indicators	1.91	7.88	2.24	4.53	3.34	February
ECRI Weekly Leading Index	2.07	8.53	3.19	6.48	-2.63	April
Personal Income		0.00	0.00	0.00	0.00	March
Retail Sales	2.57	10.70	3.80	7.74	6.47	March
Retail Sales Excluding Motor Vehicles	3.09	12.93	3.43	6.98	6.04	March
Industrial Production	0.80	3.24	2.18	4.40	3.74	March
Number of Unemployed	-3.24	-12.33	-8.81	-16.84	-7.01	March
Announced Layoffs	-9.35	-32.46	-67.27	-89.29	-8.78	March
Output Per Person	0.48	1.94	0.90	1.82	0.48	December
CPI - All Urban Consumers	0.91	3.69	0.98	1.97	2.65	March
Personal Consumption Expenditures	0.52	2.08	0.95	1.91	1.65	December
PPI - Finished Goods	0.47	1.88	0.31	0.62	2.81	March
CRB Commodity Spot Index	3.23	13.56	-1.31	-2.59	-13.51	March
Gold Price	1.30	5.30	-5.54	-10.77	17.54	March
Oil Price	7.73	34.70	24.04	53.86	3.16	March
Housing Starts	-0.57	-2.26	19.32	42.36	34.75	February
New Single Family Home - Sales	-2.80	-10.72	7.93	16.49	11.39	February
New Single Family Home - Median Price	9.24	42.41	2.56	5.19	6.33	February

Actual Value / Diffusion Index

	Current Value	3 Months Ago	6 Months Ago	1 Year Ago	
Phili Fed Survey - General Activity - 6 Months Ahead	32.90	40.00	25.20	59.20	March
Phili Fed Survey - New Orders - 6 Months Ahead	36.40	44.10	24.60	54.90	March
Consumer Sentiment	75.30	64.10	55.70	77.50	February
ISM Purchasing Managers Index	53.40	53.10	52.48	59.74	March
Capacity Utilization - Total	0.00	78.53	77.66	76.99	March
Unemployment Rate	8.20	8.50	9.00	8.90	March
AAII Percent Bullish Investor Sentiment 8 Week Average	40.92	43.34	34.07	37.49	April
AAII BullBear Investor Sentiment Spread	-13.42	29.49	18.00	7.25	April
S&P 500 PE	14.30	13.66	15.51	16.44	December
S&P 500 PE Using 10 Year Average Earnings	20.52	19.69	22.09	22.39	December
VIX - Volatility Index	18.43	27.80	31.62	18.35	February
3 Month Treasury Yield	0.07	0.01	0.02	0.10	March
1 Year Treasury Yield	0.19	0.12	0.11	0.30	March
5 Year Treasury Yield	1.04	0.91	0.98	2.21	March
10 Year Treasury Yield	2.23	1.93	1.99	3.47	March
30 Year Treasury Yield	3.35	2.91	3.03	4.52	March
Aaa Corporate Bond Yield	4.04	3.79	4.10	5.16	March
Baa Corporate Bond Yield	5.30	5.18	5.38	6.06	March
Quality Spread (Baa - Aaa Bond Yield)	1.26	1.39	1.28	0.90	March
Term Spread (10 Year - 1 Year Treasury Yield)	2.04	1.81	1.88	3.17	March
Real Yield Spread (10 Yr TBond- 1 Yr Expected Infl)	-1.07	-1.17	-1.31	0.77	March