HARBOR VIEWS

HARBOR ADVISORY QUARTERLY NEWSLETTER

Winter 2012

HARBOR ADVISORY
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A LOOK INSIDE HARBOR VIEWS

- *Thoughts on the Economy* – ….stability in residential real estate pricing is a 2012 event.
- *Our View of the Financial Markets* – U.S. equity returns of 10% in 2012…

LATEST NEWS FROM HARBOR ADVISORY

- You can visit us at: www.harboradvisory.com. Take a look and let us know your feedback.
- Jack De Gan continues to make news with his regular guest appearances on CNBC's top rated financial shows "Squawk Box", "The Call", "Closing Bell" and on Bloomberg TV, Fox Business News and National Public Radio.

THOUGHTS ON THE ECONOMY

In the fourth quarter of 2011, GDP growth was 2.8%, the strongest rate in a year. Full year growth was a total of 1.7%. The trend was steadily up. The U.S bucked the trend late in 2011 of slowing growth in Europe and Asia. Some of this strength is illusory as the savings rate was reduced in Q4 to boost personal consumption: a trend which cannot continue indefinitely.

We expect GDP growth in 2012 to be in the 1.5 – 2.0% area which, although positive, is anemic relative to past post-recession recoveries. The historical growth rate is over 3%.

Growth is also unimpressive in light of the continued enormous fiscal and monetary stimulus being provided by the government. By deficit spending of $1.2 – 1.5 trillion annually we are, by definition, adding that amount of fiscal stimulus. The Federal Reserve continues to aid the economy with 0% interest rates and a $2.6 trillion balance sheet of mortgages and government bonds to hold rates down. Even record low mortgage rates near 4% created by Fed policy have done little more for the housing market than to slow the rate of price decline.

We do believe however, 2012 will be the year that residential real estate prices stabilize in the U.S. which will boost consumer confidence and bank capital.

We remain concerned our political leaders on both sides of the aisle fail to deal with our enormous budget deficits and debt accumulation. Our national debt crossed $15 trillion in 2011 and is now over 100% of GDP. Spain, which is facing financial difficulty, has a more favorable ratio. Only our reserve currency status allows us to finance these deficits. It is high time we face our responsibility to the next generation and reform entitlements, reduce spending and reform the tax code. This can be done but requires political will.

Oil prices remain elevated at $110/barrel for Brent Crude as Iran continues to threaten to close the Straits of Hormuz to shipping. The domestic U.S. energy situation is improving however as our country now imports 47% of its energy needs, down from 60% in 2006. Natural Gas production has exploded with the technology to fracture shale and drill directionally. Our government should do all it can to encourage this process while maintaining appropriate oversight.

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"The S & P 500 currently delivers a dividend yield in excess of the yield on the 10 year Treasury Note…"

We provide a safe harbor for individuals and families in New England …

Most of Harbor Advisory's new clients come through referrals from our existing clients or from industry professionals who know us and how we work.

All of us at Harbor Advisory value these referrals as the greatest compliment our small, independent firm could receive.

If you know an individual or family who is seeking counsel and might appreciate sound, personalized investment advise and financial services we would welcome the opportunity to meet with them.

We should also approve the new Keystone pipeline proposed to transport Canadian crude to the Midwest. The government should get behind the use of natural gas in electricity generation, home heating and transportation fuels to cut our emissions, lower cost and provide greater energy independence.

OUR VIEW OF THE FINANCIAL MARKETS

In 2011 the S&P 500 gained 2.1% which was more than accounted for by the dividends paid by the components. Corporate profits probably rose over 12% for the year. The Lehman Aggregate Bond Index returned 7.8% as rates fell broadly as the European debt crisis lowered economic projections and world central banks flooded the markets with liquidity.

So what's ahead for 2012? We think 2012 could be a mirror image of 2011. In 2011 sentiment started the year positive as it appeared earnings would grow strongly and it was believed the European Stability Fund would contain the debt crisis. The outlook for world growth was for continued expansion. This year we start the year with sentiment very negative. Investors are concerned about slowing world economic growth, slowing earnings growth, political gridlock in the U.S. and continued credit contagion concerns coming out of Europe and a potential 'hard landing' in China.

This sets the stage for investors to be surprised by positive news on one or more of these concerns. We believe the European Governments, the ECB, the IMF and the ESM are making real progress on containing the debt crisis and are making real changes in the economies related to productivity growth. China could achieve a soft landing with GDP growth bottoming in the 8 – 9% range. U.S. economic growth could stabilize at 1.5 – 2.0% and provide 6 – 8% earnings growth for U.S. corporations. Dividend increases and share repurchases could also set records as U.S. companies put to work some of their almost $2.0 trillion in balance sheet cash. We expect equity returns between 10 – 20% for 2012.

International stock markets broadly underperformed the U.S. in 2011 with Europe as a whole down about 20% and the emerging markets even weaker as the U.S. dollar strengthened due to 'flight to safety' buying. This phenomenon could reverse in 2012. We expect emerging markets to outperform the U.S. this year which will be good for Harbor clients as we have significant emerging markets holdings for most clients.

The fixed income markets could reverse course in 2012 as rates rise if Europe contains its debt crisis. This would allow Harbor fixed income portfolios to perform well as the hi-yield sector outperforms. Non-dollar denominated bonds will gain if foreign currencies appreciate against the dollar. This trend is in place in January thus far.

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UNEMPLOYMENT IN AMERICA TODAY

A longstanding and very thoughtful client asked that I discuss unemployment in the Newsletter after we had a long discussion on the subject.

We receive employment figures monthly from two different sources: the ***Bureau of Labor Statistics (BLS)*** provides the ***Non-Farm Payroll (NFP)*** number. The ***Household Survey*** provides the unemployment rate. The BLS survey is conducted by gathering data from 1,000 corporations on monthly job creation and destruction. The Household Survey is a telephone survey of 1,000 homes monthly.

Currently, the BLS survey shows about 4.2 million new jobs monthly and 4.0 million jobs eliminated, or a net positive total of 200,000 job additions. To put this figure in perspective the U.S. economy needs to add about 175,000 – 200,000 per month to keep the employment rate from rising due to immigration and the U.S birthrate. The job additions figure of 4.2 million monthly is as weak as it was at the *lows* of the bottom of the last recession. So the improvement in net jobs created is not because the economy is creating many new jobs, we are just firing fewer people. The BLS survey suffers from other shortcomings as well: the figures do not capture start-up businesses which historically account for a significant number of jobs in the U.S. It also suffers from significant revisions after initial release.

The Household Survey asks questions of families to determine if they are employed or are part of the workforce. If you are not looking for a job currently, then the survey does not count you as part of the workforce, and therefore you are not "unemployed". There are multiple rates derived from the Household Survey, from the headline unemployment figure, which was 8.5% in December, to the U-6 rate which was 15.2% in December. The U-6 rate ***includes*** people who are not currently looking for work or who are underemployed by working part time. We believe the U-6 rate is more indicative of the actual slack in the labor market and shows the real weakness in the current economic environment.

TAX REPORTING REMINDER

This year again all custodians will supply capital gain and loss information to their clients on Form 1099. They will issue these by February 15th. Don't forget that K-1's may not come out until March 15th. These must be filed with tax returns so it pays to wait for these before you file.