

**LARGE-CAP CORE EQUITY**

**ALL THINGS IN MODERATION**

*Lessened Volatility Likely for Both Economic Data and Market Prices*

U.S. large-cap stocks ended 2011 almost exactly where they began despite significant volatility during the year. The total return including dividends for the S&P 500 Index was 2.11% in 2011, but the Index closed at 1,257.60, essentially unchanged for the year. Both temporary factors and more sustained shifts in the economic backdrop contributed to the ups and downs in the market last year. Investors should not lose sight of the more sustained economic drivers behind last year's market swings — some of these same drivers will likely shape the economic and market environment in 2012.

**A Look Back**

Many investors and economists at the beginning of 2011 expected strong economic growth. The consensus view for approximately 4% U.S. GDP growth in 2011, however, was quickly called into question. Economic data was mixed early in the year, and investors had to evaluate the repercussions of the Arab Spring and the Japanese earthquake and tsunami. The U.S. dollar, which had weakened early in 2011, strengthened in the second quarter after the Fed made it clear it would not extend its program for purchasing U.S. Treasury securities commonly known as "QE2." The dollar also gained as worries resurfaced about the financial health of a broad group of European countries. All these factors weighed on commodity prices and caused concerns for investors. And when weaker-than-expected second quarter GDP data was released in late July, along with downward revisions to first quarter GDP, economists cut their outlooks for U.S. economic growth.

Diminished expectations for economic growth during the summer turned into fears for some that the U.S. economy was headed for another recession later in the year. Equity markets in the U.S. reflected these fears as the S&P 500, which reached its high for the year in April, fell sharply in August and September on recession concerns and the possibility of another financial system meltdown ignited by events in Europe. The most economically sensitive Sectors of the S&P 500, like Energy, Materials and Industrials, declined the most during the late summer sell-off. The stock market then rallied in the fourth quarter as fears of a U.S. recession diminished.

The Large-Cap Core Equity portfolio was overweight the Consumer Discretionary Sector and the Information Technology Sector throughout the year, and benefitted from a zero percent allocation to the worst performing Sectors in the S&P 500 — Industrials, Materials and Financials — Sectors that typically outperform in a high growth environment. Two portfolio positions in the Information Technology Sector — Research in Motion and Nvidia Corp. —

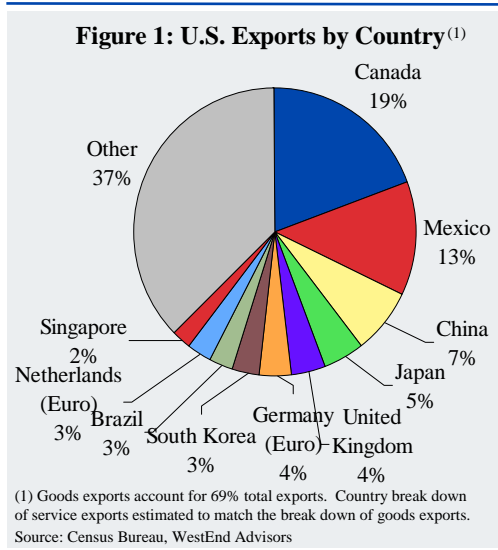
weighed on results and more than offset the positive benefits from our Sector allocations. We sold Research in Motion and Nvidia Corp. out of the portfolio during the second quarter of last year.

U.S. economic growth was reasonable, but unsatisfying to many Americans in 2011. The pace of growth actually accelerated in the second half of the year, but even that stronger growth fell short of the expectations investors' held at the start of 2011. The overall economic environment last year was in line with our 2011 forecast. The areas of strength across the economy, which included consumer spending and business investment, also matched our expectations.

**Familiar Outlook, New Questions**

We do not see substantial changes in the U.S. economic backdrop this year. We saw moderate economic growth characterized by 2% to 3% GDP growth in 2011, and this pace of growth should persist into 2012. While our economic outlook for the U.S. is similar to what we expected a year ago, investors' primary uncertainties about the year ahead have changed. The questions at the start of last year centered on the impact of higher commodity prices from emerging market growth and accommodative monetary policy. This year, investor focus is on the degree to which economic developments abroad, including possible European sovereign debt defaults and slower growth in China, will shape U.S. growth.

European growth slowed in the second half of 2011, but U.S. economic activity actually picked up over the same period. This divergence makes sense, however, in the context that U.S. exports to countries that use the Euro currency only account for about 1.5% of U.S. GDP. Another way to look at the U.S. economy's limited direct economic exposure to Europe is that exports from the U.S. to Canada and Mexico combined are 2.3 times the size of exports to the Euro area. This data gives us confidence that the U.S. economy



can continue to grow even as European economic growth might remain slow.

We continue to see limited risk of a global financial crisis sparked by Europe, but the ultimate impact of the situation in Europe is a critical unknown. European political and financial leaders, and their counterparts around the world, are determined to prevent a systematic disruption of the world financial system similar to what occurred in 2008. Even though the probability of such a scenario remains low, the severe disorder it would cause means that Europe will remain in the spotlight again in 2012. Fortunately, European Union governments have begun to take steps to lessen this risk. Short of severe difficulties being realized, news from Europe will likely move off of the front page and become less of a market factor. We also believe that the strategy used to address the U.S. credit crisis, which centered on rebuilding capital and confidence in the banks through the Troubled Asset Relief Program (TARP), provides a real-world road map for European authorities.

Europe, however, is not the only source of uncertainty from abroad in 2012. Chinese economic growth has slowed, but the impact of slower growth in China will not be felt uniformly across the U.S. economy or stock market. Materials and Industrials Sector companies will likely face the stiffest headwinds from a deceleration in Asian growth. China, like Europe, influences the U.S. economy, but it does not determine the pace of U.S. growth. (See Figure 1)

#### *Pillars of U.S. Growth*

Economic trends in the U.S. should shape the domestic economic environment this year. Consumer spending will be a critical driver of U.S. economic growth. Income growth remains solid. Higher earners continue to see improvement in their economic situation, especially compared with lower paid workers. The number of employed workers with a bachelor's degree or higher, for example, rose by nearly 1.1 million in 2011, as illustrated in Figure 2. In contrast, the number of employed workers with a high school diploma or less fell by more than 400,000 last year. This data highlights some potentially serious social challenges, but from an investment perspective, it also highlights that the fundamentals for high-end consumer

spending remain strong. The financial health of the highest earners is critical as these consumers account for a disproportionate share of consumer spending, and thus drive overall consumer spending.

Initial jobless claims, in addition, are just above a three and a half year low, which indicates workers likely feel more secure in their jobs. Limited risk of layoffs together with solid income growth point to continued strength in consumer spending. In fact, personal spending growth in the fourth quarter of 2011 should be the strongest of any quarter last year when reported later this month. We expect that these spending drivers should remain in place in 2012 despite many investors' worries, and that consumer spending will again be a key area of strength for the U.S. economy.

Business investment was strong in 2011 as technology and other categories of capital expenditures (CapEx) continued to grow. The most recent CapEx data points to positive, but slower CapEx growth based on what will likely be temporary factors, including the expiration of an accelerated depreciation tax credit. Nevertheless, the conditions for strong enterprise technology investment endure, and have even improved as lower overall corporate earnings growth in 2012 will intensify managers' focus on projects that will enhance productivity, and in turn help boost profits.

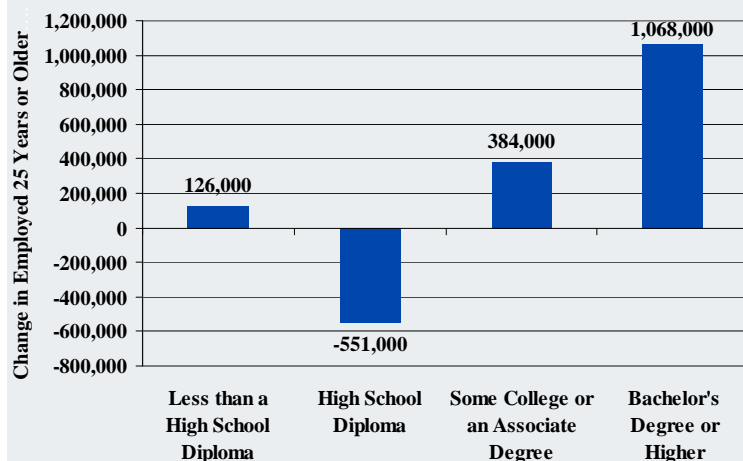
Consumer spending and business investment should continue to drive the U.S. economy. The economic backdrop, however, will evolve in 2012. Export growth, which has been one of the sustained highlights of the recovery, will likely moderate, in part from higher currency translation. Alternatively, we expect housing and construction to become small positive contributors to growth. In addition, the labor market, which is typically a lagging economic indicator, should also continue to improve. These shifts in trade, construction and the labor market will not, however, push the U.S. economy off its moderate growth trajectory.

#### *Stock Market Backdrop*

The economic environment will certainly be a key driver of stock market performance in 2012. But other factors will also influence the market. The rise of the U.S. dollar relative to other currencies was a key trend in the stock market for the last three quarters of 2011, and this trend will likely persist in 2012. The relative attractiveness of U.S. growth, together with low and falling global interest rates will support the dollar. In addition, we see limited risk of a repeat of a quantitative easing program the likes of QE2, which injected dollars into the global economic system and in turn drove down the value of the dollar and pushed up commodity prices. All of these conditions point to a headwind for dollar denominated commodity prices in 2012, and for the companies that operate in commodity-oriented industries.

This outlook for a strong U.S. dollar dovetails with consensus analyst estimates for a significant deceleration in earnings growth this year for companies in the most economically sensitive Sectors like Energy and Materials. We believe, however, that the shift down in earnings growth for companies in the most economically sensitive Sectors could be sharper than anticipated with further strength in the dollar and slower infrastructure development abroad. In addition, we don't expect Financials Sector earnings growth to reaccel-

**Figure 2: Change in the Number of Employed in 2011 by Level of Educational Achievement**



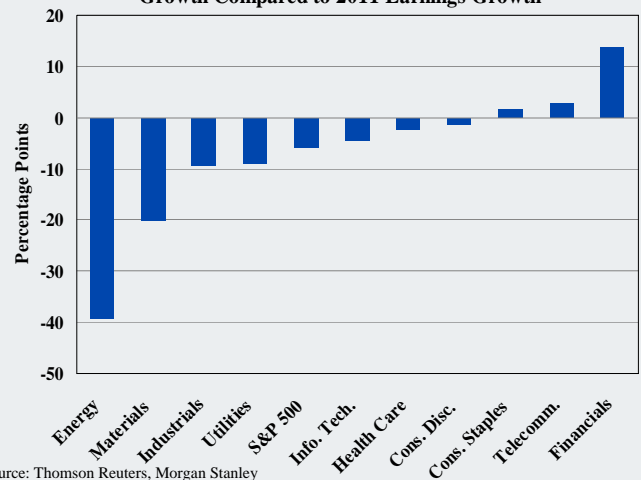
Source: Bureau of Labor Statistics

**Figure 3: S&P 500 Sector Annual Operating Earnings Growth**

	2011	2012	Difference
Financials	11.1%	24.8%	13.7%
Telecommunication Services	3.5%	6.1%	2.6%
Consumer Staples	6.6%	8.1%	1.6%
Consumer Discretionary	12.0%	10.4%	(1.5%)
Health Care	5.8%	3.3%	(2.4%)
Information Technology	14.8%	10.4%	(4.4%)
<b>S&amp;P 500</b>	<b>15.8%</b>	<b>9.9%</b>	<b>(5.9%)</b>
Utilities	3.5%	(5.4%)	(8.9%)
Industrials	22.4%	13.0%	(9.4%)
Materials	34.0%	13.9%	(20.2%)
Energy	42.1%	2.7%	(39.4%)

Source: Thomson Reuters, Morgan Stanley

**Figure 4: Percentage Point Difference in 2012 Earnings Growth Compared to 2011 Earnings Growth**



Source: Thomson Reuters, Morgan Stanley

erate to the degree that many analysts expect. Limited operating earnings growth (earnings excluding shifts in loan-loss reserves), and the continued absence of key earnings drivers like loan origination and other fees – in part from regulatory constraints on formerly highly profitable businesses – point to overly optimistic earnings growth expectations for Financials.

#### **Risks to Either Side of Our Outlook**

We are confident in our outlook, but there is the possibility that growth in U.S. could be stronger or weaker than our moderate growth forecast. If the general slow down in corporate profit growth has a more wide-spread negative impact than we currently anticipate, it could undermine personal income growth and business investment in technology. Strong personal income fundamentals, limited layoffs and continued overall high corporate profitability, however, all help to mitigate this risk. In addition, it is normal for earnings in the most economically sensitive Sectors of the market to grow at slower rates, even as the overall economy continues to deliver reasonable economic growth.

Additional stimulus from weak growth, or merely perceived weak growth, is another risk to our outlook. We believe, however, that we will not see significant fiscal or monetary intervention in 2012. There is no political will in Congress or the White House to boost spending in an election year in which the federal budget deficit will be a contentious issue. There may be some incremental accommodative action by the Fed this year, but we do not expect a repeat of the \$600 billion expansion of the Fed's balance sheet as under QE2. A repeat of QE2 would weaken the dollar, and in turn hurt growth abroad at a time when many foreign economies face difficulties. A significant new round of quantitative easing would likely provide little stimulative benefit to the U.S. economy, and could produce substantial backlash from Europe and other trading partners.

Stronger-than-expected growth is also a risk to our outlook. A number of key characteristics of the U.S. economic environment, how-

ever, keep the likelihood of this outcome low. Evidence abounds that individuals and businesses are more risk averse. Potential causes of this shift in behavior include the financial crisis, an older population and increased concern about the long-term financial strength of the U.S. But whatever the source, it is clear Americans' appetite for risk has diminished. Less risk-taking, along with less leverage in the U.S. economy, and slower growth abroad, all make a period of more dynamic economic growth in the U.S. unlikely.

#### **Positioned for the Strength in a Moderate Growth Environment**

The Large-Cap Core Equity portfolio is positioned for modest growth, which is the environment we see as most likely for the period ahead despite risks of stronger or weaker growth. The economic data swung widely in 2011, in part from the normal variability in economic activity, and in part from extraneous events like the Japanese earthquake. We expect the magnitude of the movement back and forth in the data will narrow in 2012. Smaller swings in the data, however, will not eliminate the swings in investors' opinions. But less variability in the data should lead investors to recognize that moderate growth is the most likely path for the U.S. economy. The Large-Cap Core Equity portfolio, in turn, should benefit as the portfolio is invested in market-leading companies that we believe will deliver strong, above market earnings growth in a moderate economic growth environment. In particular, the portfolio is overweight the Consumer Discretionary and the Information Technology Sectors as consumer spending and investment in enterprise technology should be key drivers of growth this year.

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