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Reading The Road Map: Outlook 2012

William B. Greiner, CFA

President and Chief Investment Officer
Lead Portfolio Manager of
Scout Global Equity Strategy
william.greiner@scoutinv.com

2012 Outlook

GDP Growth	1.80%
Unemployment	8.50%
Inflation	3.00%
Fed Funds Rate	0.12%

Overview –

Great Global Expectations, Dire Debt Realities

In general, we expect the world to be fighting a rising tide of economic challenges as 2012 unfolds. Many believe dysfunctional governments are becoming the norm on a worldwide scale. We don't agree with this stance, but believe many are currently focusing on the symptoms of the financial services and banking structure disease, rather than the actual disease itself. The world is looking for answers to two questions:

- What do we as a people expect?
- What are we willing to afford from our governmental systems?

We have written on these issues extensively in the past. Indeed our thematic piece from last year, "Black Swan Rising", centered on this question. These questions are now front and center for not only U.S. investors, but also for investors globally. The question is being aggressively addressed not only in Washington D.C., but also in Berlin, Paris, London, Rome and, certainly, in Athens.

Let us move on to the more mundane issue of accounting, and the focus of much of the world: debt. Late in 2007, we started writing and speaking on the issue, with our "Long, Hard Slog" theme. That theme morphed into the "Main Event" and the "Black Swan" themes. These economic and attendant investment thematic pieces all share one common denominator – that being the explosion of debt creation in both private and public sectors, which started in the U.S. in the mid-1980's and continued until the economic meltdowns starting in late 2007.

Since inception, the theme has taken flight, and as outlined in detail in our "Black Swan" piece, Europe is now infected with the same virus – as are many segments of the continent. As Tom Laming, Lead Portfolio Manager of Scout Small Cap Fund, puts it, they are "now running out of other people's money to spend". This is a very vivid and accurate way of portraying what is happening on a worldwide scale.

Over the period of time from 1985 to 2007, as the developed world was losing "market share" of the world's income statement to more rapidly growing countries, debt creation was blossoming. A reasonable portion of that debt was being used to support ever-rising lifestyles. In other words, the developed world's

balance sheet was being levered for current consumption purposes. Eventually, the party had to end - and end it has. The world's capital markets have little if any tolerance currently for excessive leverage creation, except of course, in Washington, D.C. There, leverage creation continues and has been actually accelerating. Sooner or later this debt creation will end in Washington as it has elsewhere, in our view. We are so certain of that statement, that it really isn't a forecast – rather the forecast portion of that statement is only “when” will this end, and how painful will this be when the end actually takes place? We, as rational investors, all know this.

The other question is – will we as a people control this end, or will the markets control it for us? I hope, and believe, we as a people will control the end of this social experiment of excess leverage utilization. Businesses and consumers by and large have made the decision to end these excesses. The peoples of the world's developed economies now need to wrestle with this issue on a governmental basis. So, for those who live on other people's money – we believe the times, they are “a changing”.

If we are reasonably accurate on our diagnosis of our problems, then we can foresee how these problems may indeed end. Make no mistake, these problems will end – it is a matter of when, and how, not “if”. As these problems end, or as importantly, as investors understand “how and when” these problems end – the world's financial markets should turn sharply into bull market territory. We believe we are some ways away from that turn occurring. However, we believe secular bear markets end and secular bull markets begin.

The Slow Road Since 2009

Our economic/capital markets outlook theme this year is an attempt to take the “Long, Hard Slog” to its next question – with the deleveraging occurring as the major world's economies continue to reduce its addiction to debt (or “other people's money”) *GDP growth rates slow*. We have seen this since the end of the recession in 2009. We view *weak GDP growth rates as a symptom*, or outcome, to *the true disease – that being excessive debt* which needs to be addressed. In other words, experiencing weak GDP growth rates during a time of balance sheet deleverage is akin to experiencing a fever while suffering from pneumonia. Those who are surprised by a slow economic growth

rate during a time of balance-sheet deleveraging don't understand basics behind economic and business realities and the concept of finite resource allocation.

We are not unfolding any new concepts (yet). Most market/economic pundits have bought into the thought that economic growth is going to be lower in the U.S. (and the rest of the developed world) than has been the case, on average, for the last number of decades. What most market/economic pundits have yet to address is the *durability of the business cycle*. *Consequently, our outlook attempts to not only address a slow-growth environment, but address the likelihood of economic contraction, due to slow growth driven by a lack of new debt creation within the private sector of the economy.*

In effect, we are looking at a historical economic roadmap and reading that roadmap as to how the U.S. economy has acted in the past during times when debt creation wasn't a central tenant to economic activity.

Back to The Future

In August, we produced a “white paper” piece centered on our belief that the business cycle has entered a much more compact period. Since 1945, the U.S. has completed 11 business expansions. We are currently experiencing the twelfth. The first eight expansions were significantly different than the next three. The most obvious difference was the length of the expansion (time between recessions). The last three business expansions lasted an average of 7.9 years. The previous eight expansions lasted an average of 3.7 years. *Why did the last three expansions last more than twice as long as the average for the previous eight expansions?*

Where Are We in the Business Cycle?

In addressing the above question, many believed business people had put practices into place which allowed businesses to “beat” the business cycle. Just-in-time inventory practices, an understanding of worldwide trade activities and “sophisticated” financial techniques led many to believe that the business cycle was becoming a thing of the past. Recessions, when they occurred, were going to be short, non-violent affairs. Additionally, some business pundits have speculated that U.S. business people have learned how to manage their businesses to avoid the danger of

economic contractions – in other words, we have learned by experience. While this may be true in some cases, the emotions of fear and greed are so powerful as to overpower rational economic experience in many cases.

To be sure, inventory adjustment strategies acted as a modifier to business leverage. However, part of the reason inventory adjustment strategies have succeeded within the U.S. has been because of outsourcing. Many companies' business models require organizations to carry significant levels of inventory to companies overseas. However, on a *global scale, inventory adjustment risks have NOT necessarily been fully eradicated* – rather they have been shifted from one geographic economy to another. On a worldwide scale, this issue has not changed dramatically.

Another reason the business cycle became viewed as “beatable” is attributable to the theory that the U.S. economy has become much more service-based rather than industrially-based. There is some truth to this, but looking at data, rather than just hearing jingo concepts is important. Following is data – from the BEA – that suggest the overall fabric of the U.S. economy didn't change radically over the last 20-year period (period of extended business cycle behavior).

1988 - 2009	Annual Growth Rate
All Segments of GDP	2.35%
Services Producing Segment	2.32%
Good Producing Segment	1.89%
Government Segment	3.48%

As can be seen from the table, services have become more dominant in overall economic activity than the Goods Producing segment of the economy. But, contrary to popular opinion, on an annual basis, the growth in the services-based economy hasn't been dramatically different than the economic growth rate overall. What stands out is the increased dominance of government spending in overall economic activity than was the case before 1988. *The “spread” in growth rates between the services and goods producing segments of economic growth has been less than one-half of one percent per year. This is hardly the full story behind a doubling in the length of the average business cycle.*

What is the Reason?

If indeed the business cycle is still in existence, **why did the period of expansion between recessions stretch from 3.7 years to an average of 8.8 years?** Let's talk about excessive debt creation. From 1945 to 1985 the ratio of total credit market debt (all debt outstanding in the U.S.) to GDP ranged from 135% to 170%. From 1985 to 2007 that ratio exploded to 375% of GDP. We propose that the main reason the business cycle extended (doubled in time) following 1985 was primarily due to an expansion in debt in relation to the size of the overall economy. As a matter of fact between 1982 and 2011, for every \$1 of GDP growth, \$2.40 of debt was created. From 1945 to 1982, for every \$1 of GDP growth, \$1.21 of debt was created. In other words, the economy in the earlier years was not addicted to debt creation, as was the case in the more recent period.

So, we are now going through a period where the economy isn't growing simply by leverage. The last time our economy was in this type of growth profile (lack of debt creation) was a period marked by short business cycles. Consequently, *we believe the probability of a recession occurring over the next 12 months is higher than many currently believe. This is NOT our base case, but the probability of an economic contraction may be rising as 2012 unfolds.*

Three Different Routes, Same Destination

When looking at a roadmap, in most cases, there are different routes from one location to the final desired destination. Projecting economic outcomes is no different. We currently see three potential economic outcomes for the U.S. specifically, and much of the developed world. Let's drill down to the U.S. first.

Summary – GDP Growth Expectation

	Historical Probability	Current Probability
Strong Growth (above 3.4%)	58%	10%
Moderate Growth (1.8% to 3.4%)	26%	25%
Weak Growth (less than 1.8%)	16%	65%



Route 1 Slow Growth Outlook: 60% Probability

Since the end of the 2008-2009 recession, the U.S. economy has grown at an annualized rate of 2.49%. This is compared to the average annual growth of the economy of 3.2% since the end of WWII. GDP growth has been steady, and very unspectacular. **Historically 83% of the time the U.S. is out of recession, and growing.** Investment (capital) spending tends to be reasonably robust, and job creation normally is occurring, absorbing the growth in the labor force.

Due to the activity of deleveraging by the private sector, we believe the economic growth rate has been low, and will continue to be lower than normal.

Deleveraging is occurring due to several factors:

- The “shock” effects which occurred in the American psyche in 2008 – 2009 when the wake-up call was received that we as a nation have been living beyond our means.
- The wealth destruction which occurred during 2008. More than 20% of the net worth of the average American household was wiped out during 2008. This, by a multiple, was the single largest year of wealth destruction our country’s households have faced since the Great Depression.
- The aging of the population is occurring. Over the last 20 years, the average age of the U.S. population has increased by 12.2% to 36.9 years. At the same rate of increase, in 20 years, the average age of the U.S. citizen will be in line with the current demographic profile of many countries in Europe. Many in the U.S. know this, and we may face a period when the country can’t afford to offer retirement income/health benefits which have been afforded to prior retirees.

These factors have led us to the view that savings rates have risen, at least for the private sector of the economy. Indeed, savings rates through the end of 2010 showed a marked increase, growing at the greatest rate our country has seen since the end of WWII. We view the factors mentioned above as not particularly transitory. Consequently, we believe

savings rates will continue to be higher than has been the case over the last 10 year period.

Rising savings profiles are negatively impacting consumption growth rates, on the margin. Additionally, it appears *unemployment levels above 7% are becoming systemic*. As unemployment levels remain high, consumption is affected negatively in two ways.

- As 9% of the workforce is not currently drawing paychecks, by definition consumption patterns will be negatively affected, which draws GDP growth rates down.
- In a self-enforcing “vicious circle” businesses are not hiring – because the visibility of growth going forward is deeply in question. There are a couple of explanations for this. One, the economic growth rate itself (both real and nominal) are extremely low, consequently the growth in demand for additional products/services is weak. Additionally, businesses can’t absorb the risks inherit in many expansion plans, due to a lack of visibility of policies coming from Washington D.C. regarding regulation and taxation rates.

It is a combination of these two factors which is driving many businesses to maintain a low hiring growth rate, further irritating the trend against hiring. With savings rates higher, consumption growth rates are lower.

Ability – Yes, Willingness – No

For transactions (economic activity) to occur, those transacting need both the *ability* to transact and the *willingness* to do so. The ability to transact can be measured by growth in income or an ability to take on debt to facilitate the transaction. Personal income levels have been rising – slowly – and corporate income levels have been rising rather rapidly. In addition, business leverage is low. Consequently, it appears to us that the *ability* to transact, or create economic activity, is present in the private segment of the economy. The *willingness* to do so, on the other hand, is sorely lacking.

To measure the willingness to transact, we look at sentiment data – basically data which measures both the consumer and business’ willingness to commit to economic activity. First, looking at the consumers’ willingness to transact we view the University of Michigan’s Consumer Sentiment Index. This index is

currently reading 75.1, down from a recent high of 87. Not too long ago (prior to the last recession) this index was showing readings in the 110 to 115 range. To make matters worse, the “expectations” segment of this index is setting multiple-year lows at 51.8, which matches the lows we saw in 1980! To say the consumer is discouraged, and concerned would be an understatement. Most of us are aware that the consumer represents a full 70% of overall economic power. We believe the variables which are leading towards these low readings in sentiment are centered in the employment data, which remain very weak.

Enter the business sentiment data. Certainly, for businesses to make investments, including hiring more capacity, they need not only the *ability* to transact, but the *willingness* to do so. Recently, the NFIB Index of Small Business Optimism was showing readings at 89.9. Putting this in perspective, between the years of 1981 and 2007 this sentiment index *never registered below 90. Over that long, 26-year period, which included three separate recessions, small business optimism was never as low as it is today.*

A lack of visibility regarding future demand patterns and costs of doing business (health care, taxes, wages, inflation, banking system concerns, European dislocation) are all driving the small business person to the position of not wanting to place capital at risk. The animal spirits normally associated with those who are willing to take business risks appear to be currently lacking. It is our opinion, after talking with a number of small business people face to face about this issue that the seemingly inability of our leaders in Washington to come to a consensus on tackling our nation’s problems is one of the points of frustration for business people, which has led to a level of not being able, or willing, to make expansion decisions. We don’t see this logjam clearing until after the next national elections and even then the process may be difficult.

**Associated Evidence
Leading to a Continuation of Slow Growth**

Following are individual data points which lead us to believe that economic growth will remain slow for the next 4 quarters:

	Current Reading	Historical GDP Result
University of Michigan Consumer Sentiment Index	75.1	2.60%
Conference Board's Expected Business Conditions	-1.30%	-0.80%
Total Level of Credit Market Debt to GDP	Above 270%	1.60%
Net National Savings Rate	Below 3.20%	1.80%
ISM Composite Index	51.0	2.60%
ISM Non-Manufacturing Index	53.0	1.80%
Personal Consumption Expenses as % of Income	92.1%	<u>2.70%</u>
Average Expected GDP Growth of Various Factors		1.75%

The data shown isn't to say that we are calling for GDP growth to come in at 1.75% for 2012 – rather this shows on various *fronts – consumer, sentiment, business trends – that GDP growth may indeed be lower-than-normal during 2012.*



**Route 2
Recession: 30% Probability**

A recession (by most folks’ definition – two straight quarters of a contraction in real GDP growth) is not our “core” case call, but based on historical standards, we need to emphasize our probability of a recession occurring is much higher than the “base line” case would suggest. As previously discussed, we believe we are in a deleveraging environment – one where debt creation isn’t playing and won’t play a meaningful role in the overall growth rate of economic activity. From a historical perspective, when our economy has experienced this environment where debt creation was not a major issue, the business cycle was much shorter than has been the case over the last 25 years. We, once again, believe we are in that type of cycle – where expansions will not only be shallower than has been the case historically, but also the period of business expansion will be shorter.

During the period of 1945 to 1985, debt creation wasn’t a major driver behind economic activity, as was the

case from 1985 to 2007. During the post-war period mentioned, the business cycle was a 5 year affair – 4 years of expansion followed by 1 year of contraction. This was the “average” or typical business cycle. Consequently, the economy had a 20% chance of being in recession at any time during that 40-year period. We currently believe, given the slow growth environment which we expect, coupled with the continued “balance sheet” problems radiating from Europe, that **the U.S. faces a much higher than normal probability that a recession may occur during 2012.**

Areas that need mentioning in this piece that suggest risks are rising for recession. First, Europe. We believe *the odds are high that Europe is currently in recession.* If this recession occurs, and it is light, then the overall macro impact on the U.S. (and the rest of the worlds) economies should be manageable. However, if indeed a European contraction occurs, and it is heavy than the odds of the U.S. falling into a recession increase. This isn't only due to a negative impact on our exports to Europe (which represents about 19% of our overall export activity) but also the impact on China. Europe is China's leading trading partner – and a meaningful slowdown in Europe will mean China may indeed be heading towards an economic “hard landing”. If this occurs, one of the world's major growth drivers will be at risk. This could move the U.S. into an outright economic contraction. *So, all eyes are currently looking to the east – watching what is happening in the European debt/currency and banking saga.*

We rest part of our case that the U.S. will escape recession over the next 12 months on the six-month rate of change of the Leading Economic Indicators. This data stream has been uncanny in its ability to forecast the starts and endings of recessions since the end of WWII. According to the Conference Board, the U.S. has experienced 10 recessions since 1950. The six-month rate of change of the Leading Economic Indicators has shown a negative reading of -3.5% prior to the start of each of those recessions – bar none. It is rare in the world of economics to find an indicator with (historically) a batting average of 1.000. Currently, the six-month rate of change of the LEI is +3.7%. *The U.S. hasn't, since 1950, entered a recession when the index has been this high.* Now, the index may move down rapidly, particularly if the situation in Europe

becomes extremely dicey. Once again, paying attention to what is happening on a world-wide scale is highly important.



Route 3 Strong Economic Growth: 10% Probability

We need to recognize the possibility that the economy may indeed grow more rapidly than “trend” would indicate (growth greater than 3.3%). Due to many factors mentioned above, we believe this possibility is very low. Consequently, we won't dwell on this probability, but simply recognize its existence.

What may occur that would change our minds about the pace of economic growth? First, a consensus would need to be reached in Washington regarding the long-term federal deficit, one that leads to serious debt reduction. Second, European leaders need a solution to their dislocation, as well as a settlement regarding the future structure of the Euro area. Should these two events happen, it would lessen the number of shackles that business people currently are forced to bear, in our view.

The adoption of the Simpson/Bowles plan (or a similar plan) may indeed be a great step in the right direction, but we believe given the current state of deadlock in Washington, this activity is highly unlikely. For the economy to start a trend of more rapid growth, these structural issues will need to be addressed, and successfully.

Call us skeptical. However, we believe the more likely outcome from the “Group of 12” may indeed be disappointing. If nothing concrete is released from Washington regarding this major issue, forced spending cuts apparently would start to take hold at the end of 2012, which would eventually have significant economic ramifications. Additionally, increased taxes may start to impact the overall macro-economic environment as 2012 comes to an end.

We believe the hurdles for the economy to grow in excess of 3.3% are very high indeed. Political issues, business and consumer sentiment, deleveraging and

the malaise in Europe all weigh heavily against a true rapid economic expansion.

Our Numbers

We have laid out three viable scenarios for GDP growth over the next four quarters. Following that period, we see the probability of recession, already at 40%, potentially increasing. However, focusing on 2012 leads us to our “core case”, where economic growth should be positive, but weaker than “normal”. This in our view will be the case not only in the U.S., but also for the majority of the world.

	2011(e)	2012(e)
Real GDP Growth	1.5%	1.80%
Personal Consumption Growth	1.50%	2.00%
Fixed Investment Growth	6.00%	6.00%
Housing Starts (base 628k)	0	0-100k
Unemployment Rate	8.90%	8.50%
Fed Funds Rate	0.12%	0.12%
10-Year Treasuries Rate	2.00%	2.40%
S&P 500 Earnings Growth Rate	10.00%	6.00%
Inflation (CPI)	3.50%	3.00%
S&P 500 Price Forecast Range	---	1,050 –1,320

As can be seen from above, we believe economic and corporate profit growth will be positive for 2012. Additionally, we think interest rates will show some degree of push to the upside, as we expect inflation “settling” in the 3% range. Note our expected GDP growth rate at 1.8% - not high enough to move the needle significantly on the employment picture – which in itself should continue to lead to a very puny consumption growth profile.

Another Challenging Year

From an economic perspective, we believe 2012 will prove to be another challenging year as the world’s financial markets may face further uncertainties regarding balance sheet risks – centered mainly in Europe. Additionally, gridlock in Washington will probably continue, in our view. It will be a national election year, and politicians weighing the benefit of passing major initiatives against anxiety those passages may create at home.

Income statement risks – economic growth, inflationary pressures, etc. – may at times appear trivial, as Europe may indeed continue to garner significant attention. We will address the European challenges in a separate piece. In that piece we will discuss at length our view towards global economic issues, broken down by geographic region. Please stay tuned for this piece.

As stated, we believe 2012 will be a year of economic uncertainty. Market volatility should remain high. We suggest volatility, if treated properly, brings opportunities to long-term, quality-oriented investors.

If our views towards the economy and markets are reasonably accurate, 2012 may prove to be a year of risks, but also rewards.



William B. Greiner, CFA

President and Chief Investment Officer
Lead Portfolio Manager of Scout Global Equity Strategy
Scout Investments

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