

HIGHLIGHTS

an economic & market review

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The Cyclical View. The Eurozone is stumbling toward a “grand solution” to its sovereign debt and banking crisis, but German Chancellor Angela Merkel, through her chief spokesman, said that a solution would not be found soon and the process “surely extends well into next year”. Meanwhile, European bank liquidity continues to decline as depositors transfer funds to U.S. banks and interbank lending dries up. There is a feeling among analysts who delve into the minutiae of daily commentary and political maneuvering that policy measures sufficient to contain the crisis in the near term will be agreed upon soon. Odds are quite slim, however, that a comprehensive solution is in the offing given Chancellor Merkel’s message. Germany is the key player to watch as this drama unfolds. As the strongest country in Europe, Germany will significantly influence coming events.

Ultimately, banks in the Eurozone must be recapitalized and Greek debt written down to a realistic level. Spain and Italy are “too big to fail” and something must be done to prevent speculative contagion from driving yields higher in these countries thereby destroying the private market for their bonds. Ireland and Portugal, while not as critically important as Spain and Italy, still require attention and of course funding or guarantees to support their financing needs. The cost of building a firewall around critical areas and dampening speculation will be high. That means the European Central Bank (ECB) will probably need to act as a lender of last resort with the International Monetary Fund assuming an important role as well. It is an extraordinarily complex problem and there can be no painless resolution. The core countries of the Eurozone and those on the periphery will, depending on individual circumstances, experience default and depression (Greece almost certainly), austerity and slow growth for a number of years.

Recession risks remain elevated. A downturn seems likely in the Eurozone next year even if the debt crisis is contained. The UK is thought to be in recession now. Developed areas of the world in

general look more vulnerable economically than the emerging or developing regions. China, however, is a special case and a hard landing there would hurt other emerging economies in Asia. China’s banks and a related “shadow banking” system look shaky according to some observers. The growth slowdown underway in China could turn into something worse if key financial entities start to topple. Recent reports indicate that in response to budding financial distress, the Chinese government has been buying shares in banks, and authority has been granted to certain municipalities and provinces for the sale of bonds ostensibly to shore up local balance sheets. The consensus on China’s economy leans toward the soft landing scenario in part because the political ruling class is viewed as being quite adept at managing the country’s economic affairs. As growth rates decelerate, however, beneath the business as usual expectations of the China watchers, an element of doubt is beginning to surface.

In the U.S., the weight of evidence continues to suggest that a new recession is not imminent, although a few models and leading indicators with respectable track records are signaling that a downturn is likely in the not-too-distant future. In late 2007 through early 2008, there was more unanimity among the indicators. The odds bet then was that a recession was approaching. Unfortunately the indicators were not flashing crash warnings. The comparative disparity that exists now among the business cycle indicators and models may reflect the special circumstances that suppress activity following a balance sheet recession as opposed to the typical post World War II downturn generated by tight money conditions, excessive business inventories, and a temporary fall-off in demand.

Normal recoveries do not follow credit busts and market crashes. It could be that in the “new normal” environment of deleveraging and only moderately positive GDP growth, some recession-signaling indicators may not carry the same weight as before. In any case, we continue to believe that the evidence supports a slow growth, muddle-through outlook for the rest of the year.



Current valuation estimates . . . justify a balanced investment portfolio allocation that includes both stocks and bonds.

Going into 2012, the structural impediments to growth exposed in the aftermath of the crash will still be with us.

Economies and markets will also remain hostage to politics and policy. The bullish outlook calls for slow growth and muddle through. The bearish outlook is recession. Globally, a muddle through forecast looks reasonable, but this mildly positive picture will likely be marred by downturns, almost certainly in much of Europe and perhaps in the U.S.

The U.S. stock market, using the S&P 500 as a measure, declined 20% from the 2011 peak in late April to the close on September 30.

At that point, cyclical valuation measures had improved enough to suggest that expected returns over the next several years might approach 7% to 8% annualized, a substantial improvement from the low single-digit return probabilities that existed a few months earlier. The decline also appeared sufficient to discount slower GDP growth going forward and perhaps even a mild recession. These return estimates, it should be noted, are based on modest economic growth assumptions. As of October 30, 2011, a stock market rally had retraced slightly more than half of the previous decline propelled by waning fears of a U.S. recession in the near term, and prospective action by the Europeans to contain their debt and banking crisis.

Valuation measures are not particularly useful as market timing indicators, but they do provide useful information about the current risk/reward picture given reasonable and rational estimates of economic growth in the future. Poor valuation readings imply an overvalued market, higher risk and lower prospective returns. Good valuation readings suggest an undervalued market, lower risk and higher prospective returns. We would call the cyclical valuation picture that existed at the end of the second quarter “good”, which is on the high side of neutral. Current valuation estimates following the rally are somewhat lower, but still at a level that justify a balanced investment portfolio allocation that includes both stocks and bonds.

Speculating about the near-term outlook for common stocks generally, our best guess is that volatility will remain high with political and monetary policy decisions having a significant impact on security prices. According to one research source, common stock price movements have become more correlated than at any time in the past 80 years. The historical evidence shows that return correlations fade in the long run as individual security fundamentals have a greater impact. We do not think the future will be any different in that regard, but during the third quarter, and for that matter much of the past couple of years, the good, the bad and the ugly have been going up and down together.

Looking at the broad market averages, a penetration of the April highs is possible but doubtful. The growth rate of corporate earnings, broadly speaking, peaked in 2010 and is decelerating. Realistic estimates indicate that composite earnings growth in 2012 will correspond more closely to the expected trend growth in nominal (not inflation adjusted) GDP. That would mean a rise of 4% to 5% at best unless profit margins continue to expand, an unlikely occurrence. This kind of environment does not support a general expansion of price-to-earnings multiples. Consequently, if investors are not willing to pay more for earnings tomorrow than they are today, potential gains in the market indices, under this scenario, would be modest.

The Secular (Long-Term) View. Following the bursting of the technology bubble in 2000, we speculated that it would mark the beginning of a secular bear market for common stocks of indeterminate length. During the past 11 plus years, economic and financial trends have continued to confirm that initial assessment. For readers not familiar with the secular bear concept, it refers to an extended period of flat or declining prices for the primary common stock indices such as the capitalization weighted S&P 500 Index (SP 500) or the price-weighted Dow Jones Industrial Average (DJIA). Secular bull cycles follow and precede secular bear cycles and show extended periods of generally rising common stock prices with relatively infrequent and shallow declines. There are no hard and fast rules to follow in identifying long-term bull and bear cycles, but our particular preference is the methodology used by Ned Davis Research which considers a number of factors including the “duration and strength of the advance or decline, inflation adjusted returns, and economic backdrop.” A significant feature for common stock investors to note is that common stocks have been overvalued (price/earnings ratios high) at the beginning of secular bear cycles and undervalued (price/earnings ratios low) at the beginning of secular bull cycles. The starting and ending dates of secular bear cycles vary somewhat among market historians, but all share common characteristics such as political and social turmoil, weak economic growth, deflation or high and rising inflation. The existing secular bear, to date, has been driven by the weak growth and deflation with social and political turmoil becoming a prominent feature following the last presidential election.

Including the current experience, there have been three secular bear cycles since 1900 using Davis’ calculations:

- 1929-1942 (The Great Crash, Depression and Deflation)
- 1966-1982 (The Great Inflation)
- 2000-2011 (The Technology Bubble, The Credit and Real

. . . conditions supportive of a new secular bull market could arise during this time frame.



Estate Bubble, The Great Recession or perhaps more accurately The Great Contraction)

When might the secular bear of the 2000s end? Looking at the length of bear cycles in the past and considering research focused on the aftermath of credit busts, our guess has been that the excesses of the last credit bubble would be fully expunged sometime between 2015 and 2018, given historical precedent. The implication is that conditions supportive of a new secular bull market could arise during this time frame. An Economic Letter published by the San Francisco Federal Reserve, “Boomer Retirement: Headwinds for U.S. Equity Markets?”, August 2011 by Zheng Liu and Mark M. Spiegel, suggests that we might need to wait a bit longer for the next secular bull market to emerge. Liu and Spiegel noted that historical evidence points to “a strong relationship between the age distribution of the US population and stock market performance.” The authors are not the first to examine the relationship between demographics and common stock returns, but they do appear to be the first to forecast the probable path of stock prices (market indices) using a projection of the market price/earnings ratio based on statistical studies which indicate a close relationship between the market P/E and the relative size of the middle-age cohort, age 40 to 49, to the old age cohort, age 60 to 69. The authors call this the M/O ratio. This ratio, in the author’s opinion, is the most relevant when measuring saving and investment behavior. Since 1954, the P/E and the M/O ratio have been highly correlated. For example, they found that “between 1981 and 2000, as baby boomers reached their peak working and saving ages, the M/O ratio increased from about 0.18 to about 0.74. During the same period, the market P/E ratio tripled from about 8 to 24.” This coincided with the 1982-2000 secular bull market. The baby boomers began to age after 2000 and the M/O ratio and P/E ratio “declined substantially.” The secular bear market emerged during this period. The M/O ratio will continue to decline for another ten years, bottoming sometime between 2020 and 2022, suggesting that this might turn out to be the longest secular bear market in more than 100 years. There are certainly influences other than demographics on long-term swings in stock prices, but Liu and Spiegel’s research covering the period 1954 to 2010 indicated that the M/O ratio “explains” more than half of the historical movements in the market P/E ratio, thereby enabling projections to be made concerning future trends

in the P/E ratio. If you can project the future trend in the P/E ratio, then, write Liu and Spiegel, “predicting stock prices is straight forward if we can project earnings, the E part of the ratio.” They assumed that in the decade to come, inflation adjusted corporate earnings “will grow steadily at the same average 3.42% annual rate by which they grew from 1954 to 2010.” After running the numbers, they concluded that real or inflation adjusted stock prices would show little improvement, if any, until after 2021. At that time they project an average P/E ratio of about 8. Currently the trailing twelve month P/E is about 13. If this analysis proves prescient, the market indices will be range bound for another ten years.

Investment asset returns during earlier bear cycles and the cyclical price pattern traced by the market indices exhibited certain similarities. Investment returns generally conformed to the following patterns:

- Negative inflation adjusted returns as measured by the primary stock market indices
- Comparable to superior returns from bonds or cash equivalents versus common stocks
- Superior returns from common stocks representing smaller companies or the “average” stock represented by an equal weighted index where the price or total market value of each security is ignored in the index construction

Investment asset returns during the current bear cycle are strikingly similar to the historical pattern, as illustrated in the following table, covering the period from January 2000 through September 30, 2011. Total return calculations are annualized and CPI inflation is highlighted for comparison purposes.

	Return	Standard Deviation
BarCap US Corporate High Yield Bonds	6.83	10.94
BarCap US Agg Intermediate	6.14	3.00
MSCI Emerging	5.12	24.38
S&P 500 Equal Weighted	5.07	18.94
Russell 2000	3.43	21.64
US Bureau of Labor Statistics Consumer Price Index All Urban Seasonally Adjusted	2.55	1.19
BarCap US Treasury Bill 1-3 Month	2.43	0.59
S&P 500	-0.39	16.18
MSCI AC World EX USA	-0.66	18.85
<i>Source: Morningstar Direct</i>		



Active asset allocation and security selection/diversification by region, sector and industry will remain key drivers of investment portfolio returns.

While return patterns thus far in the cycle correspond to what we might see when the cycle is measured from its beginning to its end, presumably about 8 to 10 years hence, the index return spreads shown in the table will probably be different. Much depends on what happens to the inflation rate. Higher inflation in the future would mean greater relative returns from cash equivalents, for example, and relatively poor returns from bonds. If inflation remains stable at current rates, then the total return of the major stock market indices, given current valuation measures, could be around 5% annualized, far better than the -0.39% annualized return for the S&P 500 index shown in the table. Unfortunately, such an outcome going forward would still mean total returns of less than 2% for the S&P 500 Index over the entire period, whether we are talking about 20 years ended in 2020 or 22 years ended in 2022. A return this low over twenty years is rare historically, but not unprecedented. The previous low for trailing 20 year returns was 1.89% as of August 31, 1949.

If this secular bear cycle lasts another decade, what kind of cyclical price action can we expect from the market averages along the way? In addition to broadly sharing economic, social and financial characteristics, the bear cycles, including this one, also show similar cyclical behavior in terms of economic recessions/recoveries and corresponding stock market declines/advances. The more serious economic downturns and stock market declines generally occurred in the early to middle years of the cycles. This was when bubbles were bursting and imbalances of one kind or another entered a corrective phase. This was when market index price lows were set for the entire cycle. "Valuation lows" in terms of P/E ratios generally came later, preceding or coinciding with the beginning of the next secular bull market. Here's what the price cycles looked like in each of the two earlier secular bear cycles using the Dow Jones Industrial Average as an example. To simplify the illustration, valuation lows (P/Es) are assumed to occur at the end of the cycle.

	1929 – 1942	
Beginning Price	DJIA 380	1929
Price Low	DJIA 41	1932
Valuation Low	DJIA 94	1942
	1966 – 1982	
Beginning Price	DJIA 990	1966
Price Low	DJIA 588	1974
Valuation Low	DJIA 772	1982

The current cycle is not complete, but the index price cycle could be tracing out a similar path. Our working assumption is

that the 6530 level on the DJIA, reached in March 2009, represents the index price low for this cycle. The valuation low and the beginning of the next secular bull cycle lies somewhere ahead, possibly in the early 2020s as suggested by the P/E and demographic analysis.

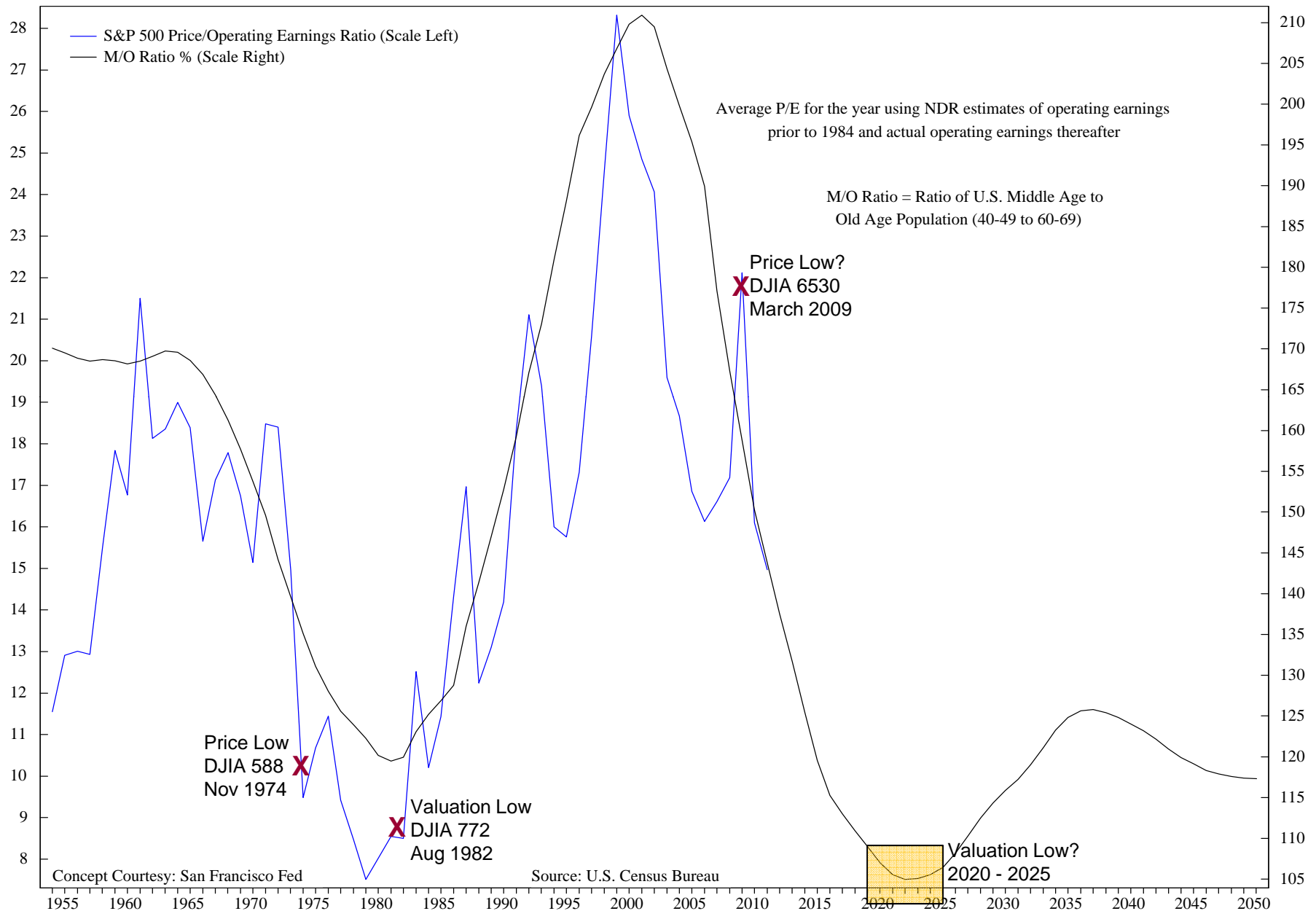
In investing as in life, nothing is certain and the future may not resemble the past. Other factors not currently known to us may intervene and change the picture completely. At the moment, however, the weight of financial, economic, political and social evidence suggests that the second decade of the new century will be just as challenging as the first. Active asset allocation and security selection/diversification by region, sector and industry will remain key drivers of investment portfolio returns.

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Ned Davis Research produced their version of the San Francisco Federal Reserve's M/O ratio in chart form, and it is included in this report. The blue line on the chart portrays the average yearly P/E ratio for the S&P 500 Stock Index since 1954. The black line is the Davis M/O ratio percent projected out to 2050. We added the price and valuation low points for the Dow Jones Industrial Average during the 1966-1982 secular bear market to the P/E line. The assumed price low for the DJIA during this bear cycle is also indicated. The valuation low, according to this concept, would be expected to occur in the area designated by the box on the chart.

M/O Ratio vs S&P 500 P/E Ratio

Yearly Data 1954-12-31 to 2050-12-31



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