



THE FOXHALL GLOBAL OUTLOOK



JANUARY 3, 2012

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FIVE BIG RISKS HANG OVER THE ECONOMY IN 2012

I think every investor is happy the 2011 roller-coaster ride of the stock market is over. While we saw volatile movements up and down 15% to 20%, the S&P 500 INDEX ended the year just slightly down.

WE ALL HOPE 2012 WILL BE A BETTER AND EASIER YEAR FOR INVESTORS! Unfortunately, many of the same risks that plagued us in 2011 will be with us, at least for the first six months of the new year.

Our FOXHALL DEFENSIVE TECHNICAL SIGNALS are still not telling us we are entering into a long-term bear market but THEY ARE INTENSELY FLASHING A “YELLOW CAUTION LIGHT.”

This is why FOXHALL’S RISK MANAGEMENT STRATEGIES are so important in very fragile, risky and uncertain times like investors face today.

FOXHALL will continue to hold large amounts of cash and U.S treasury bonds in our client’s portfolios while there is still great risk in the stock market.

Foxhall always tries to err on the side of caution. We are always willing to give up some gain in an attempt to protect client capital.

But investors must understand that with RISK MANAGEMENT there is always a potential trade-off. An investor gives up some potential reward to manage potential catastrophic risk.

Although RISK MANAGEMENT is not always perfect, it is always important to be vigilant in trying to manage the downside risk—and it also helps to try to be humble enough to admit that we don’t or can’t know or control everything.

With FOXHALL maintaining large positions in cash and treasury bonds to in attempt to protect clients from a possible downturn in the stock market over the next few months, investors should realize that on days when the market goes up, their portfolios will probably underperform. Conversely, on days the stock market drops, they should be protected.

WHAT ARE THE BIGGEST RISKS FACING THE STOCK MARKET NOW?

I recently read a very thoughtful article by the economics and Federal Reserve expert, Neil Irwin, writing for the WASHINGTON POST. He discussed in his article, the five biggest risks facing the global economy and investors. I wanted to share a few of his insights.

I agree with him that these are some of the major challenges we will all face over the next few months.

In his article, he says, “the real reason 2011 has been such a disappointment isn’t bad luck. It’s that the problems ailing the U.S. economy are so profound that the nation can manage strong growth only when everything goes absolutely right. The confidence of businesses and consumers is more thoroughly shot than forecasters realized.”

THE POLITICAL SYSTEM IS MORE DYSFUNCTIONAL, lurching from one invented crisis to the next; unable to make easy decisions, let alone the hard ones. Problems in mortgage finance and an onslaught of foreclosures have prevented a housing rebound, even as demographics suggest one should be near.

The good news: There was no double dip in 2011. The recovery, now 2 ½ years in, appears well-enough entrenched that the challenges merely slowed growth, rather than prompting a contraction.

At the same time, such slow growth — many forecasters are predicting about the same in 2012, with projections hovering around 2.5 percent — is not enough to push joblessness down over time. It leaves little margin for error.

In other words, given the headwinds, it will take everything going right for the kind of robust expansion that would make this a recovery not just in the technical sense that economists talk about.

Five questions hanging over the economy in 2012 will determine whether that is the case or it is another year of muddling along — or worse.

WILL THE U.S. POLITICAL SYSTEM BEHAVE ITSELF?

In 2011, American politics was ugly in ways that undermined confidence and damaged economic prospects. One key to a better economy in 2012 will be a more orderly, confidence-inspiring management of the most powerful government on Earth.

There was the April battle over spending that nearly shut down the government. The December standoff was over whether to continue a cut in the payroll tax that both parties agreed to in principle. But



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most damaging was the summer brinkmanship when many House Republicans threatened to block an increase in the debt ceiling — which would have meant a default on U.S. debt.

Even after a deal was struck, STANDARD & POOR's cut the U.S. government's credit rating, blaming the downgrade on the reduced "effectiveness, stability and predictability" of American policymaking.

It is no coincidence that job growth and a range of other economic measures suffered a lull, falling just as the debt-ceiling debate heated up. Executives described a sense of exasperation at the process. There is a lively debate over the proper role of government in American life and the proper level of taxes to pay for it — but those doing the hiring would rather that debate unfold without the threat of default and downgrade.

It would be good for the economy in 2012 if Congress and the Obama administration could arrive at deals to keep the government running without such fireworks. It probably won't happen. Take the deep divide between the two parties on the direction of the country. Add in election-year politics. Again: UGLY.

The first test will come in February, when payroll taxes are set to rise unless action is taken. Congress and the White House made a deal to extend the tax cut by two months to buy time, but there is every reason to think the talks ahead will be just as difficult as those last month.

Absent an agreement, the typical American worker will see his or her paycheck decrease by \$20 a week for the rest of the year, which would probably weaken consumer spending and thus overall economic growth.

Late in 2012, the stakes get even higher. The tax cuts President George W. Bush enacted in 2001 and 2003 are scheduled to go away Jan. 1, 2013, absent congressional action. The standoff will be between (either a newly re-elected or newly defeated) President Obama and a Congress with the same composition but one that could also contain plenty of lame ducks. It's anybody's guess how it turns out.

CAN EUROPEAN LEADERS BALANCE EVERY COUNTRY'S DEMANDS?

The fate of the U.S. economy rests, to a surprising and somewhat scary degree, in the hands of German Chancellor Angela Merkel, European Central Bank President Mario Draghi and the other leaders of Europe who will collectively decide whether that continent fixes its financial troubles or lets them spiral out of control.

The pattern has been in place for two years: When it appears that the European debt crisis is worsening, the impact rapidly ripples across the ocean. First the U.S. stock market drops — American companies have lots of customers in France and Italy and Spain, after all. And within months, job growth slows and the nation has entered another economic lull, a far-too-common occurrence since the recession ended in mid-2009.

That's what happened in spring 2010 and again in early 2011. The question is whether Europe will be a force for good or ill in the U.S. growth picture in 2012.

The answer rests with Europe's leaders. U.S. officials, most notably Treasury Secretary Timothy F. Geithner, will be a sounding board and source of pressure for action rather than decision makers.

The most likely scenario is that Europe — already looking to be in a recession — keeps limping toward a greater fiscal union, to accompany the monetary union already in place. That will mean the nations of Europe giving up some control of their power to tax, spend and borrow, but gradually instilling confidence that there will be no more countries behaving like Greece, borrowing far beyond their ability to repay.

But even in that likely scenario, there have been no straight lines in this crisis. For more than two years, in so many summits that insiders have trouble keeping them straight, it has taken a dramatic financial-market decline and brinkmanship by European leaders to trigger action just before it's too late and the euro zone — and decades-long move to



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a united Europe — collapses.

SO THERE ARE TWO TYPES OF RISKS. One is that the sacrifices needed to preserve the currency zone and prevent a global financial collapse become too much to bear for the political systems of one or more of the nations of Europe. So far, when unpopular governments have fallen — in Spain, Italy, Portugal and Greece — they have been replaced by coalitions committed to maintaining European unity. But if the pain of austerity combined with the loss of sovereignty becomes too great, anti-euro populists could gain power.

A SECOND RISK IS SIMPLY THAT OF POLICY MISTAKES. In the high-stakes poker going on between Germany, France, Italy, the European Central Bank and the International Monetary Fund, someone might call a bluff that wasn't a bluff at all, and the world financial system could be in peril in the same way it was in fall 2008.

All that said, Europe could be beneficial to the U.S. economy in 2012, as well. Markets have priced in some bad outcomes in Europe. If the era of muddling through gives way to a more consistent, credible version of European unity, and the European recession turns out to be mild or nonexistent, it could create a stock market rally and boost business confidence — and hiring — worldwide.

BLACK SWAN EVENTS: WILL WE BE LUCKY ENOUGH TO AVOID AN X-FACTOR?

Here's how you'll know the economy is back on track: when economic analysts no longer spend lots of time explaining how random, unpredictable events are behind weak growth.

In the past year, the list included the Arab Spring and its accompanying rise in global oil prices, supply disruptions from the Japanese earthquake and tsunami, and Hurricane Irene in the fall.

The truth is that while all of this can meaningfully affect when economic activity happens — say, the first quarter vs. the second — it doesn't really tell much about the underlying trends in the economy. And when the economy is good, these random events mean almost nothing.

Consider 2005. The U.S. economy was humming along, with full employment and steady growth. Hurricane Katrina hit in August, destroying swaths of New Orleans and the Gulf Coast, and disrupting, among other things, a key link in the supply chain through which agricultural products from the Midwest are shipped down the Mississippi and to the world.

But go back into the gross domestic product and employment data from 2005, and there is barely a ripple. That's because when the economy is strong, even seemingly big blows are manageable. It's the nation's underlying weakness that makes these random events seem so economically consequential. Something that moves growth from 2 percent to 1.5 percent seems like a bigger deal than something that moves it from 4 percent to 3.5 percent.

All that said, a bit of good luck — meaning no surprise disruptions — would be awfully helpful.

WILL THE HOUSING MARKET BOTTOM OUT?

If 2012 is to be a year of robust growth; housing will almost certainly be key. And while it doesn't look likely that the long-depressed sector will be booming anytime soon, there are reasons to think it will start to contribute to growth.

For one, the nation has been under-building houses — constructing and renovating too few homes to keep up with population growth — for half a decade.

At first, that drop in construction was making up for the excesses of the boom years. But the great collapse may have overshot, at least in terms of construction. With 1.2 million households created each year in normal economic times



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(young people and new immigrants), the roughly 600,000 or fewer homes started in each of the past three years aren't enough to fulfill that demand.

And while there may be an oversupply of houses in places where the bubble blew biggest, such as Phoenix, Las Vegas and much of Florida, there is demand in places that had less oversupply then and have stronger economies now, such as Washington, San Francisco and Texas.

Even with homeownership rates drifting downward, people have to live somewhere, and recent gains in housing starts have come primarily from apartment buildings and other multifamily properties, which are usually rentals. From a broader economic view, that's just fine. Any newly built housing unit puts construction workers back on the job.

Even so, big problems in housing finance could hold the sector back for another year. A flood of foreclosures is holding down prices, which makes developers reluctant to build.

Residential investment has been just more than 2 percent of overall economic activity in the past two years, down from 6 percent at the peak of the housing boom and a 4 percent long-term average. Just returning to that historic trend would add about two percentage points for economic growth.

And we'll need it. Housing seems better poised than any other major components of GDP to offer a positive surprise — considering consumer spending is weighed down by weak growth in incomes, government spending is constrained by political paralysis, exports will be challenging amid a slowing global economy, and business investment has been rising at a steady clip.

CAN CHINA MANAGE A SOFT LANDING?

The crisis in Europe isn't the only overseas threat to the U.S. economy. Troubling signs in recent months suggest that the Chinese growth juggernaut could be slowing, which raises risks for the United States and beyond.

China has been a rock through the tumultuous past half-decade, its government responding nimbly to the 2008 crisis and emerging as a source of stability in the global economic order. The question is whether Chinese leaders can guide their economy to a soft landing, engineering overdue economic changes without having growth stall out.

China's recent growth has relied overwhelmingly on exports of manufactured goods and investment, particularly in housing. Both are at risk: Exporters could be stung by the likely European recession, and the Chinese housing market is showing signs of deflating.

The latter trend, a possible popping of a Chinese housing bubble, poses the greatest risk to the world's No. 2 economy — and, by extension, countries that do business with it. That's because China responded to the last bout of weakness, in 2009, specifically by easing bank lending requirements. That made more money available for housing, helping drive up construction activity and prices.

In other words, the Chinese response was to pump up the housing market. It worked. But that strategy also contributed to its current dilemma, stoking speculation on housing. China's goal is to allow the housing correction — sales and prices are down sharply in the past two months — to proceed gradually.

Can China shift to greater reliance on domestic demand for consumer goods and services, and away from exports and housing, without a major recession that could endanger global growth? That answer could help determine the health of the U.S. economy in 2012 and beyond."

WHERE DO WE GO FROM HERE?

For all the reasons stated above there are real risks in the global economy that will have an effect on the stock market



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over the next six months.

THE ONLY SANE INVESTMENT STRATEGY IS: CAUTION!!!

As I mentioned earlier, FOXHALL will continue to hold large amounts of cash and U.S treasury bonds in our client's portfolios while there is still great risk in the stock market.

However, I do believe that once this current correction is over and there is a sustained upward trend in the stock market that OUR FOXHALL PROCESS COULD POTENTIALLY OUTPERFORM THE STOCK MARKET GOING UP AND I HOPE THIS WILL HELP MITIGATE RECENT PORTFOLIO DECLINES.

Until then...

PATIENCE!

—Paul Dietrich

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