



THE FOXHALL GLOBAL OUTLOOK



DECEMBER 1, 2011

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THE STOCK MARKET ROLLER COASTER RIDE ISN'T OVER YET!

Although we have seen a first-rate rally in the stock market this week, investors sometimes have short memories. Just last Friday, the S&P 500 INDEX was down -7.34% for the month of November. The market gained all of that loss back again over the past three days.

During the past six months, the stock market has been nothing short of manic—there has been no consistency—only volatility. The stock market has not seen this level of up and down days since 2008.

Investors have all witnessed a number of days where the market was down 3% or more one day and the next day rallied back 3%. Since the beginning of August, the S&P 500 INDEX has seen 29 swings of 1% or more in a single day.

Perhaps this type of volatile, sideways market reflects the mediocre economic news from around the globe. Asia and Emerging Markets are slowing, Japan has flat growth, Europe looks to be heading for a recession, and the U.S. is still growing—but at a very slow pace.

DESPITE THE GLOOM—THERE ARE SOME BRIGHT SPOTS

In my August 5, 2011 GLOBAL OUTLOOK newsletter I predicted that, contrary to popular belief at the time, the U.S. **was not** going to slip into a double-dip recession. In that same newsletter I predicted that consumer spending had bottomed and I gave all my reasons why we would shortly see a rebound in U.S. consumer spending. We are now clearly experiencing that consumer spending rebound after the start of the Thanksgiving and Christmas shopping season.

Another important bright spot is corporate earnings, which in normal times should be driving the stock market. Globally oriented U.S. companies are estimated to grow their earnings by 15% this year. U.S. corporations have over \$2 trillion in cash on their balance sheets and very little debt. Sales in Asia and Emerging Markets reached record highs over the past 12 months. Over the past year corporate productivity has also reached record levels.

Capital spending by businesses is up. Consumer confidence is trending up. Household debt continues to contract and banks are also continuing to write down their bad debt and improve their balance sheets. Both housing and factory data shows signs of picking up and most importantly, U.S. GDP continues to expand. We are also seeing private sector jobs starting to significantly increase. This may be the first real sign of an economic recovery.

BUT WE ARE NOT OUT OF DANGER YET!

With all these positive indicators, why do investors feel like the stock market is taking them on the worst roller coaster ride of their life? THE ANSWER IS POLITICS!

The stock market has been reacting primarily to political issues for the past 6 months. First the U.S. debt ceiling debate, then the U.S. debt downgrade by Standard & Poors (that was a political decision), the failure of the so-called congressional “Super Committee”, and now the European debt crisis.

WHY SHOULD AMERICANS CARE ABOUT THE EUROPEAN DEBT CRISIS?

I believe the stock market would be a lot calmer and a lot higher if it were not for the European debt crisis.

Make no mistake about it if the European politicians do not get their act together soon, economists are very worried about another global financial disaster. If this were to happen, the stock market would react very badly.

Yesterday the world’s central banks, including our Federal Reserve, launched a massive joint action to provide cheap, emergency U.S. dollar loans to banks in Europe. While the stock markets went up in some relief that someone was taking decisive action in this crisis—this action is a real cause for alarm. The central banks acted out of a growing fear that the global financial system was in danger of collapsing.

While this injection of liquidity into European banks may cause the stock market to go up for the next month or two, this action only buys European politicians a very short period of time to come up with a real plan to solve this crisis.

WILL EUROPEAN POLITICIANS DO THE RIGHT THING? Will they act responsibly and cut their spending and reign in scofflaw nations like Greece, Italy, Spain and Portugal?

The U.S. is in far better shape than Europe and our politicians in congress and the so-called “Super Committee” have miserably failed at trying to cut a small \$1.2 trillion from our budget over the



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next 10 years. Why do we think European politicians, who love their entitlements more than we do, will be any more successful?

THIS IS WHAT IS AT STAKE IN THE EUROPEAN DEBT CRISIS—& WHY IT IS SO DANGEROUS!

The European debt crisis could cause a global financial and banking disaster worse than what we experienced in 2008-2009. Europe would be ripped apart by sovereign defaults, bank failures, wild currency swings and capital controls.

There's more. Europe's problem is not just that governments are over-extended. There are an unknown number of European banks that are effectively insolvent if their holdings of government bonds were "marked to market"—in other words, valued at their current rock-bottom market prices. Recently, some banks are refusing to lend to other European banks.

Just as European banks loaded up on all our U.S. subprime mortgage bonds, most big U.S. banks have some exposure to euro-zone bonds or banks. One U.S. institution—MF Global, run by former senator and former Goldman Sachs CEO, Jon Corzine—just declared bankruptcy because of its highly leveraged euro-bond bets.

THE U.S. MAY BE NEXT

There is another reason Americans should care about this European financial crisis. We may be next. What is happening in Europe today may happen here very soon.

Italy's debt amounts to 121% of its GDP. Today the U.S. gross federal debt stands at around 100% of GDP. Four years ago it was 62%. By 2016 the International Monetary Fund forecasts it will be at 115%.

Some economists believe that our debt is less of a problem because, unlike Italy, we can print money. That means that the U.S. has the ability to get rid of our debt by inflation or depreciating away the debt.

This is not very reassuring to U.S. investors who hold a significant amount of treasury bonds as part of their retirement savings. Inflation will cause those U.S. treasuries to be worth a lot less in purchasing power in the near future.

HOW DOES ONE INVEST IN THIS ROLLER COASTER STOCK MARKET?

At FOXHALL, we are carefully watching all of these events every day and trying to react in a prudent way to protect our client's principal. The protection of principal against potential catastrophic loss is absolutely paramount at this time. For us at FOXHALL, the protection of principal is far more important than short-term stock market gains.

SOME HAVE CRITICIZED FOXHALL FOR BEING TOO CONSERVATIVE. Our system can seem a little slow getting out of the market and a little too slow getting back in. But when you are riding a stock market roller coaster that can go up one day by 3% or 4% and go down just as much the next day I THINK A STRATEGY THAT IS TOO CONSERVATIVE MAY BE THE BEST STRATEGY FOR THIS TYPE OF STOCK MARKET.

With markets regularly moving more than 3% a day, I do not believe it will be difficult to make up recent portfolio declines once the stock market enters into a "sustained uptrend." But until then, FOXHALL WILL MAINTAIN ITS VERY CONSERVATIVE STRATEGY OF MAINTAINING SOME EXPOSURE TO THE STOCK MARKET COUPLED WITH LARGE POSITIONS IN CASH, U.S. TREASURIES AND MONEY MARKET FUNDS.

This policy of maintaining significant cash positions will be a drag on performance on days when the stock market rallies up. FOXHALL will underperform on those days. But, for the same reason, we could outperform on those days that the stock market declines.



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AT FOXHALL, WE ALWAYS WORRY MORE ABOUT STOCK MARKET DECLINES AND PRINCIPAL LOSS THAN WE DO ABOUT SHORT-TERM GAINS.

WHEN WILL THIS STOCK MARKET TURMOIL END?

What the central banks did for Europe yesterday was more of a Band-Aid than a real fix. While their actions were welcomed by the stock market, this rally could last through December and into the first quarter of 2012. But the reality is that Europe (and the United States) still have a very big problem and it is a four-letter word called “debt.”

At some point this European debt crisis will be resolved—and hopefully without first causing a global financial and stock market meltdown. When this European political crisis is finally resolved the stock market should rally sharply because basic company fundamentals are currently so strong. When that happens, FOXHALL will most likely move fully back into the stock market.

But, because there is still a real and significant risk of a global financial crisis hanging over the stock market, FOXHALL will continue to pursue our cautious and conservative strategy of maintaining significant amounts of cash and treasury bonds in an attempt to protect client principal until this stock market roller coaster ride is over.

Until then...

Patience!

—Paul Dietrich
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