



Fourth Quarter 2011 Report

Dear Valued Client:

2011 ended on a relatively positive note for United States investors. For the quarter, the Dow Jones Industrial Average was up 8.38% and the S&P 500 up 7.11%, bringing the full-year result for the Dow Jones Industrial Average to a positive 5.5% and leaving the S&P 500 about flat for the year. U.S. fixed income results were also positive for the year with long-term Treasuries up 29.93%, intermediate Treasuries up 6.57% and the Municipal Bond Index up 10.70% for the year. Volatility continued. During 2011, the S&P 500 increased or decreased by 2% or more on 35 days. News flow, particularly from Europe, seemed to drive investors from “risk on” to “risk off” and back on nearly a daily basis.

Investment returns in the rest of the world were dramatically less good. The broad STOXX Europe 600 Index was down 11% for the year. The European sovereign debt crisis continued to overhang the markets and impact economic activity in Europe and beyond. Emerging market performance was even worse with China down 21.6% in local currency terms, India down 24.64%, Brazil down 18.1% and Russia down 17.6%. Commodities also fared poorly in 2011. The DJ-UBS Commodity Index was down 13% for the year. Oil was down 8.2% for the year, and copper 23% for the year after spiking higher in the first quarter. Agricultural commodities were up modestly for the year but down from their mid-year highs.

The improvement in the U.S. equity markets reflected improvement in the United States economy. GDP growth, which had slowed to 1.3% in the second quarter, increased to 1.8% in the third quarter and appears to have accelerated to close to 3% in the fourth quarter. The S&P 500 companies earned about \$99 per share for the full year in 2011, an increase from \$84 in 2010. The Conference Board's Leading Economic Indicators continue to increase with the LEI up 0.5% in December. The Conference Board's Consumer Confidence Index showed a surprisingly strong increase, with the index in December at 64.5%, up from 55.2% in November. The Institute for Supply Management's Manufacturing Index was at 53.9 in December, up 1.2% from the prior month. The Non-Manufacturing Index was also up in December to 52.6 from 52.0. Those indexes have been reflecting economic growth for 25 and 29 months, respectively.

In the United States, housing and employment have been the major negative factors holding down greater economic growth. Housing continued to be a weakness in the fourth quarter. According to the Case-Shiller Index, home prices continued to decline, with prices down 1.1% in October from the prior month. On a year-to-year basis, prices are down 3% compared with the prior year and are about 32% below their highs. The reduction in household wealth caused by the decrease in housing values continues to negatively impact consumer spending.

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The employment picture has brightened a bit. The United States economy added 100,000 jobs in November and an additional 200,000 jobs in December. The unemployment rate declined to 8.5% in December, down from its high of 10.0% in March 2010. If the employment situation continues to improve, it could give economic growth a boost.

The Federal Reserve Board continues to monitor the pace of the economy, carefully mindful of its dual mandates to control inflation and maintain employment. Members of the Federal Open Market Committee expect economic activity to continue to expand in 2012 at a moderate rate. They acknowledge that global strains, particularly the European debt crisis, pose risks to this outcome. However, better employment results or housing improvements could also result in stronger growth. The Federal Open Market Committee continued to pursue its policy of extending the average maturity of the securities held on its balance sheet by reinvesting the proceeds of maturing securities in longer-dated replacements. The intent in pursuing this program is to push down long-term interest rates. The Fed is concerned about the impact of the poor housing situation on economic growth, and it has recently begun to suggest to other policy makers that steps ought to be taken to break the logjam created by defaulted mortgages and foreclosures. The Fed has gone so far as to suggest that Fannie Mae and Freddie Mac ought to be willing to take greater current losses in order to allow the housing market to adjust and move forward and in doing so, reduce the ultimate cost of working out of their delinquent mortgages.

The sovereign debt crisis in Europe is unresolved. European and international organizations and governments have taken steps to address budget deficits in several countries and their impact on the integrity of the debt of these countries. Although progress has been made, it is hard to be confident that the problem has been solved. If a lack of confidence spreads to the larger European economies, the impact will be hard to contain. At a minimum, fiscal austerity and banks shrinking their balance sheets seem to have pushed Europe into a recession. Reduced demand from Europe will harm companies in the United States.

Looking ahead, the economy in the United States should continue to expand in 2012, albeit at a modest pace. Threats to growth are the impact of the European sovereign debt crisis, high unemployment and the continuing decline in housing prices. While any of these factors could derail the recovery, if they do not, this should be a reasonably constructive environment for equities. Standard and Poor's estimates that the S&P 500 companies earned \$99 per share in 2011 and projects that they will earn between \$105 and \$110 in 2012. With the S&P 500 closing at 1289 on January 9, the market is trading at 13.0 times the trailing 2011 earnings and between 11.7 and 12.3 times projected 2012 earnings, a relatively modest valuation, leaving some room for price improvement if actual results meet or exceed expectations.

Yours truly,

Hemenway Trust Company LLC

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