

January 20, 2012

**MONTHLY SUMMARY FOR DECEMBER¹
AN ECONOMIC REVIEW AND PREVIEW**

While humbling, I always maintain that those who forecast should review how bad their sight was. Hopefully, model errors might be corrected by seeing why reality differed from quantitative estimates, though new model errors are sure to develop. Sometime ago, the Federal Reserve of Boston reviewed forecasts over an extended period and concluded that using last year's growth rates normally did almost as well. Indeed, models without intervention (except to set policy assumptions) did the worst of all forecasting tools. Judgment by experienced forecasters outperformed the models on almost every variable. However, judgment using models to provide a guide was better than judgment alone.

As last year began, Ben Bernanke declared that sustained growth had been achieved. Most forecasters agreed. I was a bit skeptical because a strong Christmas was the result of savings reductions, but I thought housing was nearing a bottom and a weak dollar would aid export activity. Also, while I fretted about commodity inflation, I thought real wages would grow. I saw the reversal of homeownership costs and expected it to raise the core rate of inflation, as it did.

Some of the weakness early in the year could not be anticipated. A hard winter caused an even sharper first quarter correction than anyone expected. Then the tsunami disrupted the supply chain, undermining auto and electronics shipments from Japan. No model could have anticipated these events, which substantially slowed economic growth even as supply friction added to pricing pressures. Indeed, computer prices actually rose during the summer while higher auto prices caused the core to rise faster in the spring and summer than I expected.

However, the surge in commodity prices resulting in a peak in April was only partially caused by those external events. The Chinese stimulus program had been too successful, causing a surge in commodity prices as growth jumped beyond 11%. Soon Chinese inflation was increasing toward 7% and wage pressures also were intensifying in China. The initial response to these global imbalances was hoarding in commodities (most hedge funds moved aggressively into commodities, much to their ultimate performance regret). Also, the Arab spring led to supply chain disruptions for sweet oil from Libya. As the world scrambled to find alternative sweet crude, oil prices surged.

Ultimately, crop production in the Northern hemisphere was adequate, but wet weather and flooding raised serious concerns about crop availability, especially after surveys suggested that corn and wheat stockpiles were historically low. The dry lands of the Southwest and China also suffered serious drought conditions that threatened cotton availability. Again, hoarding accentuated the price spikes in those commodities, though high ethanol use of corn continues to threaten low cost feed for animals.

On top of this most unusual year was the increasing failure of the euro system. Interest rates on Greek bonds jumped so high that all the taxing capacity in Greece would need to be used to pay interest as those bonds were refinanced. While the problems were not that acute in Ireland or Portugal, bailout funds were provided to replace bonds that could not be rolled over. As the year ended, Greece was seeking relief from its creditors (though without formally declaring default or leaving the euro) while Italy became the latest country to pay more than 7% to roll over their 10 year bonds. Draghi replaced Trichet after midyear and promptly worried more about sovereign debt liquidity than

¹ The Monthly Summary is prepared by Dr. Donald Ratajczak, PhD., Morgan Keegan's Consulting Economist. Additionally, this report is a transcript of comments made by Dr. Ratajczak and should be read in that context. Additional Information Is Available Upon Request.

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inflation. Relief was slow, but some patchwork success was evident at the end of the year.

While all these major events were happening elsewhere, the U.S. Congress threatened the “good faith and credit” of the United States before compromising on a process creating a super committee that since has failed to resolve the budget battles. Because of the failure to act in Congress and the apparent absence of alternatives by the White House, S&P lowered the credit rating of U.S. treasuries much to the yawning of bond investors (though equity investors were momentarily nonplussed and discounted American enterprise ownership by 5% in a single day).

I could argue that any forecasters that were right last year simply did not understand how unusual 2011 was. Indeed, anyone who brags about forecasting honors for the year better explain how they knew all these unusual events would unfold (or that the events really had no impact upon the U.S. and global economies). I will not accept the argument that all these diversions should be accepted as normally happening though the exact form of them could not be known in advance. 2011 was an unusual year.

OK, enough with the excuses. I was not close in my forecasts of a year ago. I did expect some slowing early in the year, but not of the magnitude that occurred. The tsunami and commodity surges notwithstanding, I had expected enough growth to allow expansion to enter the investment accelerator phase by the second half of the year. To be sure, disruptions lowered the utilization of capital and delayed investment for expansion purposes, but the attitudes that prevented business from expanding never really changed.

I also underestimated the budget adjustments needed by state and local governments. I now believe the state governments have right sized their budgets, but the local governments continue to struggle with declining revenues from reduced tax digests. I clearly will be more aware of these imbalances in future forecasts.

The collapse of a balanced policy approach to economic issues also was not fully understood. No one seriously believes the Federal government can be run with 18% of the GDP given all the entitlement promises that currently exist. Until those promises are adjusted, budget battles will continue. In the meantime, economic thrust from government policy must come largely from the Federal Reserve. I did not fully appreciate this a year ago (nor did Bernanke, though he learned). After the expiration of QE2, Ben took a new approach by announcing a freeze on policy rates (the so called zero lower base federal funds policy) through at least the middle of 2013. Of course, I had hoped that stronger economic growth would allow some unwinding of Federal Reserve stimulus by the beginning of 2012.

The implications of this shift in policy balance obviously meant that I was wrong on interest rates. Long rates now had a two year window where they competed with zero short term rates. In the absence of any rising inflationary risk, this automatically lowers the yields on long term bonds. I was expecting the core to creep higher and thought that would stay the hand of the Fed. Instead, the commodity surge was ignored by the Fed (correctly, in my opinion) and the core now is growing about the same as a year ago even with the beginning of some rent pressures.

Most of my errors come from failing to anticipate the commodity price surge. I had food and fuel adding 0.6 percentage points to the core inflation rate. In fact, the add factor was almost two full percentage points. Instead of some modest growth in real earnings, the average worker actually suffered more than a percentage point decline in purchasing power. Most of that decline was met from reduced savings, but consumption also suffered (though the magnitude of that decline was accentuated by the auto supply problem).

The early weakness in economic growth discouraged corporations, who actually reduced their inventories by summer. This might allow stronger growth in 2012, but I certainly did not anticipate the inventory liquidations in 2011. Needless to say, corporations were not willing to invest in expansion (except for power, the one strong growth area in construction spending). They remain wary as this year begins, but the gap between returns on existing assets and expectations of returns on new assets has rarely been higher. If growth persists, some spending for expansion should surface in 2012.

As I already mentioned, I also failed to realize how much adjustment remained in the government sector. The job losses are not over, though the 30,000 per month that occurred early in the year are now down to less than 15,000 per month. I am hopeful that local governments will right size by the middle of this year, though my model does not have the tax flows needed to assure that result.

I was hoping that exports would be a growth vehicle and they were early in the year. At that time, the world was slowing from more than 5% growth in 2010 (using IMF measures), but I could not see the tightening in policy in China and the shift from lending to emerging markets by Europe that slowed global growth to 4%. Also, the euro problem reversed the decline in the dollar. I had projected a trade weighted index of 98.1 for the year, but with relatively slow decay. In fact, the trade weighted index averaged 97.2, but with a reversal after midyear. Today, that index is 100.6. Virtually no one expected the dollar to rally so strongly in the second half of the year. While exports remain stronger than underlying growth, their contribution to growth has

been halved by the slower global growth and stronger dollar. This reduced competitiveness will weigh on growth in 2012.

Housing began to provide additions to growth during the year, mostly because of improving activity in rental construction. Housing prices continue to fall, though the rate of decline has slowed. If rents rise more strongly, the cost of sitting on the sidelines may become intense enough to begin the recovery process in single family units. The latest sales have been promising, but the weather has been unusually mild (a substantial aid to sales during the winter). Let's see if sales can be sustained in the spring. My guess is that rental construction will allow positive contributions from housing, but the single family price will not improve until late this year.

While lower rated bonds also rallied in 2011, the big gains were in treasuries, which received a fright premium. (Fright became so large in Europe that some short term German bonds were sold above par, meaning that investors paid a storage fee for the German government to hold their funds.) Whether that fright premium rises or diminishes depends upon whether the sovereign debt crisis morphs into a European financial crisis. I believe the patches will buy time, probably into next year, but more clearly needs to be done. However, the longer a crisis is delayed, the lower fright becomes according to my psychology friends.

I will discuss the equity performance more fully in its allotted section. However, lower interest rates and higher profits (I estimated a gain in after tax operating profits of \$93 billion while reality appears to be \$134 billion) should have raised the value of American enterprise. While the S&P averaged a higher value than the year before, there were virtually no gains during the year. I had expected about an 8% gain for the year. Perhaps, the normal gain was delayed because of all the unusual events of 2011 and it will appear in 2012. I will discuss that below.

Some of the key assumptions in making my 2012 forecast are as follows:

- a) The Fed will maintain a policy price freeze into 2014, but not past January of that year. No additional QE's or other Fed action is expected.
- b) The payroll tax holiday will be extended for the remainder of the year, but will be paid by higher premiums on Medicare over the ten year planning horizon. Extended unemployment also will continue, but only through 79 weeks. No other fiscal changes are expected. (This means that the Bush tax code will not be

substantially altered when it expires at the end of this year.)

- c) Europe will suffer a mild recession, but avoid a financial crisis. This will be accomplished by a combination of increased ECB lending to banks, austerity measures in the challenged countries, and increased competitiveness from a lower value for the euro.
- d) China's policy will become more accommodative, allowing their growth to bottom at 8.5% and their inflation at 4%. No commodity spike is expected following this year's Chinese New Year.
- e) There will not be supply disruptions of any magnitude this year and crop yields will be adequate (though I am watching the Southern hemisphere drought).
- f) Both houses of Congress will be Republican though the White House race is too close to call.

Using these assumptions, I arrive at the forecast table located at the end of this report.

CREDIT MARKETS

A stronger dollar and lower treasury rates suggest that the world wanted more than the additional \$1.3 trillion in bonds that were provided by our deficit. We cannot always count on flights to safe havens to finance our government. Given my assumptions about supply chain flows and the European crisis, the safe haven effect should diminish this year. International investors are not likely to continue shipping their savings to the U.S. once the "fear factor" diminishes. Of course, if my assumptions are wrong and the fear factor is justified, then flows could remain intense. The most likely assumption is that a substantial reduction in our deficits will be needed to stabilize the dollar and prevent rising long term rates, even with the freeze in short term rates.

During the first half of the year, international flows should not be a problem. A strong dollar and continuing fear will combine to maintain flows with little regard to returns. By the second half of the year, however, the volume of additional debt may begin to alter the decisions of international investors. They will still finance our deficits, but they will require higher returns to do so and the dollar may begin to dip. Indeed, the Fed may feel some pressure to abandon ZLB in 2013, though I still believe the most likely assumption is no change in policy until early 2014.

The December federal deficit was \$85 billion as opposed to \$78 billion the previous year. However,

outlays have been falling 2.3% so far this fiscal year while receipts are rising a modest 4.4%. Assuming timing issues caused the December uptick in the deficit and that the quarterly average is more indicative of the trends in government activity and using my fiscal assumptions, the deficit will be slightly under \$1.1 trillion for the year (or slightly higher than projected by the administration). This is about a quarter trillion less than last year's deficit, but still a very large number (e.g., over 6.5% of GDP).

The big question is what will happen to the Bush tax codes and the payroll tax holiday as they again expire at the end of the year. I am assuming the extended unemployment benefits will be sharply limited, cutting about \$50 billion from annual outlays. Also, the payroll holiday will not be extended, adding more than \$100 billion to revenue. At this point, the easiest estimate is to assume extending the Bush tax code, though its expiration would dramatically lower near term deficits (and substantially slow the economic recovery). When that is combined with some outlay reductions following the super committee debacle, I arrive at a deficit of slightly under \$800 billion for the following fiscal year. Again, I am assuming something on that level will be needed because international investors will increasingly become unwilling to finance our deficits.

Early in the year, the fright factor should allow financing at little change in interest rates and even some further improvement in the value of the dollar. The pressures will build later in the year, and the modest reduction in the deficit may become a pressure point at that time. (Of course, as the time when the ten year is competing with ZLB diminishes, the yield on ten year bonds should naturally rise in the absence of changes in inflationary expectations.)

State governments may be in a position to begin rebuilding some of their assets by issuing bonds though local governments will continue to find difficulty in setting aside revenues for borrowing needs. While operating budgets must be balanced, these increased borrowings might add modest pressures to the tax exempt market. Current spreads between the general obligation bonds and their treasury counterparts no longer show a preference for treasuries (or an investment opportunity in the general obligations). However, some rebuilding of rainy day funds may begin, so I would put the net savings used by the state and local governments near zero.

Because of the sluggish housing market, consumers are not using as much savings for investments as they are generating. However, their savings rates have been falling. I see those rates rising slightly early in 2012 and then continue to drift upward through the year. I also see modest further gains in savings in 2013, assuming no major tax changes. Housing will

slowly increase its use of savings in the second half of the year and intensify those demands next year. This suggests that the household sector will hardly change the net savings provided by the sector although private savings should rise along with housing demand.

Therefore, if the changes in uses of funds are not caused by international flows other than those outlined above, the big swing will come from the corporate sector. Currently, the corporate sector has been a surprising supplier of funds as cash flow has more than amply financed capital spending while inventories have been liquidated. The inventory investment already is changing while the growth in cash flow is slowing. Thus, the net additions to savings from the corporate sector already are falling. Modest further erosion in savings contributions is expected through the middle of this year and then the pressures should mount as corporations add inventory, begin expansion investing and continue to experience slower growth in profits. This is where pressures will develop by early next year in long term rates that might lead to abandoning the ZLB. However, the inflation rate probably will remain subdued and economic growth, while above trend, will still not be sufficient to lower unemployment below 7% before the end of next year. Thus, I believe ZLB remains until inflation intensifies and/or unemployment at least drops to the 6's.

Of course, the big uncertainty is in the international flows. They have been supportive of low interest rates in the U.S. despite strong government use of debt. My projections suggest that the support will diminish even as the corporate sector will reverse from a net supplier to a net user of funds by early next year. If fear remains, or intensifies, the rise in rates will be delayed. Indeed, investors will either buy or sell the long bond depending on their assumptions about when ZLB ends. By the second half of this year, however, most investors will probably assume that the ZLB span in the ten year bond's life will be narrowing, and rates will move higher.

EQUITY MARKETS

I already indicated that equity markets behaved unusually last year. First, they were basically flat when the third year of a bull market and the year before a Presidential election normally provide high single digit gains for equities. To be sure, the Dow achieved moderate single digit gains, but small capital stocks were down and the S&P gyrated wildly (up 8 to down 12 from April through September) before ended with little change from the previous year.

The best performing sector was utilities. Their operating costs did not fall (though the natural gas portion fell sharply toward the end of the year). Demand for their services was not robust. But they easily covered their dividends and they looked like bonds with growth potential. The next two years will not

favor bond investment, though operating costs may fall. However, low demand has developed as the year starts. I don't expect a repeat of their leadership.

The next best performer last year was consumer staples. They tend to be well known internationally, pay dividends, and are considered relatively safe. In short, ideal for international flight capital that is concerned that too many U.S. bonds are being accumulated. Some of that probably will persist early in 2012. Then I see this group drifting back to no more than a market performer.

Health care was the other solid performer in 2011, though much of their gains occurred early in the year. The impact of health reform remains unclear as the Supreme Court determines whether the Congress behaved constitutionally in mandating health insurance purchases subject to fines for employers for failing to provide such benefits. If Obama does not win re-election, most of that reform will be gutted. As a rule, the reform is not beneficial to the profits of health providers, though the health promises that cannot be met by the government may also create profit problems for the group. In short, the uncertainty remains strong and I would be surprised, in the absence of some change in medical mandates, to see this group shine again in the next two years.

However, there are some new benefits in generic producers as the statins fall off patent and even some for big pharma as some promising infectious and cancer drugs are in development. Moreover, the information technology appears to have lowered medical costs and may rebound despite reform. Probably not a strong sector, but some strong elements within might develop.

The biggest loser was finance, which I thought could rebound in 2011. While loan loss provisions have declined, so have interest rate margins. ZLB is not a profit prescription for long run banking. Also, sovereign debt problems impacted some of our larger institutions. Finally, collateral values, especially for mortgages, continued to fall. Some of these issues will persist through the middle of this year and then diminish. I hate to say the biggest loser may be a big gainer the next year (a very normal pattern), but this could be true for the financial sector. To hedge bets, I have been recommending the large regionals (e.g., Wells and Sun Trust) as examples, because they will not be impacted that much by international events.

The next worst was materials despite the early commodity market spike. Actually, orders for processed metals suggest that a rebound is possible in the processed metals. However, another commodity spike is not expected. Therefore, I think metals will remain a laggard.

Industrials struggled last year as the rebound in economic activity kept being delayed. I see better times for this group this year. I certainly think construction will rebound, especially homebuilding and also like home products, though some, e.g., Home Depot, already have rallied strongly.

Energy is another that is difficult to call. Supply disruptions could send energy exploration dramatically higher. However, my assumption is that such disruptions will not occur. Clearly, hedge inventory is being acquired in case I am wrong and that has firmed prices for oil (though natural gas prices have plunged partially because of warm weather). Using my assumptions, energy should not be a strong investment performer, though oil service countries in the U.S. may do well as new fields are opened and the lifting of the deep water drilling moratorium leads to rising activity. As a hedge, I am arguing that some domestic oil service positions should be purchased. If supply chains are disrupted, they will soar. If not, they will perform at least at market rates because of their increased activity.

I had also thought technology would do well last year, and that largely did not happen. Some of the consumer oriented technology, such as Apple, did well, but communications devices began drifting toward commodity status. The electronics supply chain was disrupted, causing some problems for system area networks and semiconductors. Those should be repaired, allowing better performance in those segments. However, security software and applications probably are the strong segments of the sector, though the stuff created by Apple still remains very attractive. In short, technology probably will be a market performer, but strong winners and large losers (mostly in the hand held devices) should be anticipated.

Finally, I see telecommunications continuing to struggle to overcome internet technology that undermines its wired monopolies. This has underperformed during the entire recovery and probably will continue to do so.

While large caps usually dominate small caps at this stage in a bull market, the on again rally should support the small cap early. More equal performance by all segments are likely in 2013, which I still see as a good year for stocks though the bull market clearly is long in the tooth. If the supply and financial shocks can be avoided, this rally should not lose steam until well into 2013 or even beyond.

MORGAN KEEGAN UNIVERSE

While the MK universe did outperform the Russell 2000 last year, the universe still lost money and underperformed the market. Our consumer services showed solid gains and easily outperformed their market counterparts, but our energy struggled and underperformed. Saying that our financials lost less

than their peers does not sound that exciting. Our healthcare services were dismal and clearly underperformed their peers. We had some big winners and big losers in technology, as I am again expecting this year (though not the same investments). While railroads and transportation equipment were standout winners, the remainder of our transportation sector largely were standout losers.

After a banner year for all of our consumer services except restaurants, I would be surprised to see the same thing happen again. Indeed, as employment growth intensifies and as paychecks get more robust, the restaurants may become one of the stronger segments. Much of the consumer performance occurred because other analysts expected less from the sector. Those expectations are higher and the consumer performance should not improve too much. Thus, smaller gains are likely this year for the group.

We ought to get positive gains for the energy sector, especially the oil service segment. However, note my caution for the sector in my comments in the equity section. I see little gain in the bond-like energy infrastructure stocks.

We are not projecting strong profit growth for the financial sector this year, but the cost of earnings certainly is low. I would look for market performance here, but might see some positive earnings surprises to boost some of the components.

We are not projecting profit gains for healthcare services, which might allow for upside surprises. However, the segment probably should be avoided until some of the rules are clarified.

Security and defense have the government as their major customer, and the government is spending less. I hope the earnings gains are correct. Otherwise, this could be one of the weakest sectors.

Our earnings projections favor the non-residential industrials more than the housing related ones, but I could see both segments among market leaders this year.

I must admit I do not understand the poor performance of the REITs. To be sure, some continue to mark down their payouts, though hoping for deals rather than meeting more stringent bank requirements appear to be the motivation this year. That certainly is not a bad thing. I see them as a buy, especially the apartment and lodging ones, but investors have not yet agreed.

Technology will again have the best and the worst. Communications equipment might be among the worst as no orders growth is apparent at this time. E-commerce and the much maligned system area networks may be among the best. I will talk more in depth in a subsequent monthly discussion.

As I believe the recovery is improving, I would buy our transportations. Commodity prices may not allow another surge in railroad activity, though initially high fuel costs will support growing intermodal activity. I also hear that truck traffic is rising while capacity remains contained. This should be a good year for the previously poorly performing trucking segments. If I had to pick a big winner, it would be air freight despite the current weakness in Asia and probable recession in Europe. However, I would wait until energy prices moderate after this supply chain fright dissipates.

I am favoring the small caps which means the MK universe may return to its 10 percentage point better performance than the market in 2012.

Percentage Annual Rates of Change

Current forecasts for several key economic variables are shown below (they reflect the chain weighted measures of GDP):

	2011				2012				2013		Ann.	Ann.	Ann.	Ann.	Ann.
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	H1	H2	2009	2010	2011	2012	2013
Real GDP	0.4	1.3	1.8	3.0	2.5	2.6	3.3	3.2	3.4	3.8	-3.5	3.0	1.7	2.7	3.4
GDP Deflator	2.5	2.5	2.6	2.0	2.4	2.3	2.0	2.2	2.4	2.5	1.1	1.2	2.3	2.2	2.3
Nominal GDP	3.1	4.0	4.4	5.0	5.0	5.0	5.4	5.6	6.0	6.4	-2.5	4.2	4.1	5.0	5.9
CPI-U (annual rate)	5.2	4.0	3.0	2.0	2.3	2.4	2.5	2.3	2.6	3.0	-0.4	1.6	3.4	2.3	2.7
CPI-CORE (a.r.)	1.7	2.5	2.4	1.5	1.9	2.0	2.0	2.2	2.3	2.5	1.7	1.0	1.5	1.8	2.3
91-Day Bills	0.1	0.1	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.2
Prime Rate	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Federal Funds	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.1	0.1	0.2
2-Yr Note	0.7	0.6	0.3	0.3	0.2	0.3	0.3	0.3	0.4	0.6	1.0	0.5	0.5	0.3	0.5
5-Yr Note	2.0	1.9	1.2	1.0	0.8	0.8	0.9	1.0	1.1	1.4	2.2	1.6	1.5	0.9	1.2
10-Yr Note	3.5	3.2	2.4	2.1	1.9	1.9	2.0	2.1	2.2	2.6	3.3	3.0	2.8	2.0	2.4
LT-Average	4.3	4.3	3.7	3.0	3.0	2.9	3.0	3.1	3.3	3.8	4.1	4.0	3.8	3.0	3.5
Aaa	5.1	5.0	4.5	3.9	3.9	3.9	4.1	4.2	4.3	4.8	5.3	4.9	4.6	4.0	4.5
Baa	6.1	5.8	5.5	5.3	5.2	5.2	5.3	5.3	5.4	5.9	6.3	5.8	5.7	5.3	5.5
Corporate Profits (\$bil)	1455	1470	1502	1547	1572	1598	1630	1668	1706	1743	1183	1408	1494	1617	1725
Operating Profits Adjusted (\$bil)	1454	1517	1559	1602	1617	1645	1671	1706	1736	1777	1090	1389	1533	1660	1757
S&P 500	1303	1319	1228	1226	1318	1376	1411	1474	1533	1576	948	1140	1269	1395	1555
S&P 500 Equil.*	1566	1718	1862	1985	2042	2078	2071	2114	2112	1978	1167	1478	1782	2076	2045
Value Gap (%)	-17	-23	-34	-38	-35	-34	-32	-30	-27	-20	-19	-23	-29	-33	-24
Dow Jones	12025	12370	11671	11799	12560	12981	13305	13897	14432	14891	8876	10663	11966	13186	14662
NASDAQ	2741	2767	2613	2601	2748	2881	3014	3163	3294	3408	1845	2350	2681	2952	3351
Trade Weighted Dollar	97.9	95.2	96.2	99.5	100.9	101.7	103.2	102.5	100.4	99.9	105.6	100.0	97.2	102.1	100.2

**This is an equilibrium value based upon discounted cash flows related to current earnings, discounted by Baa rates and adjusted for additional share supply for existing companies. I have recalibrated the estimates based upon trend peaks in stock market values*

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