

INCOME BUILDER

MAJOR POINTS:

- **MARKET ACTION:** Doom and gloom is pervasive, but I believe that there is still hope for a modest rally before the end of the year that could last into 2012. (p.1)
- **General Electric (GE):** Management anticipates double-digit earnings growth in 2011 and 2012. With the recent bump in the dividend, the stock yields 4.1%. My near-term target price is \$21. (p.2)
- **Imperial Oil (IMO):** Despite strong Q3 performance, the stock continues to lag its peers and the broader market. (p.3)
- **Cimarex (XEC):** Falling natural gas prices and difficulty in raising production levels have weighed heavily on the stock this year, but there is still good recovery potential. (p.3)
- **Enerplus Corp. (ERF):** Lower than anticipated completions due to weather-related delays have hurt the stock, which now yields 8.8%. (p.3)
- **PennWest Petroleum (PWE):** Good Q3 results due to strong commodity prices have failed to lift the shares, which now sport a 5.8% dividend yield. (p.4)
- **ACTION THIS ISSUE:** Although I am not adding to any existing positions, I rate all of the companies covered here "BUY" (p.4)

MARKET ACTION AND OUTLOOK

BY STEPHEN P. PERCOCO

Since rebounding off the November 25 low, after the world's central bankers announced an agreement to ensure dollar liquidity for Europe's banks, the stock market has struggled to hold on to its gains.

Trading action over the past five sessions suggests that the market is beginning to roll over.

From a technical point of view, the apparent failure of the market to push above its October 27 high (1292.66 on the S&P 500) is another worrying sign.

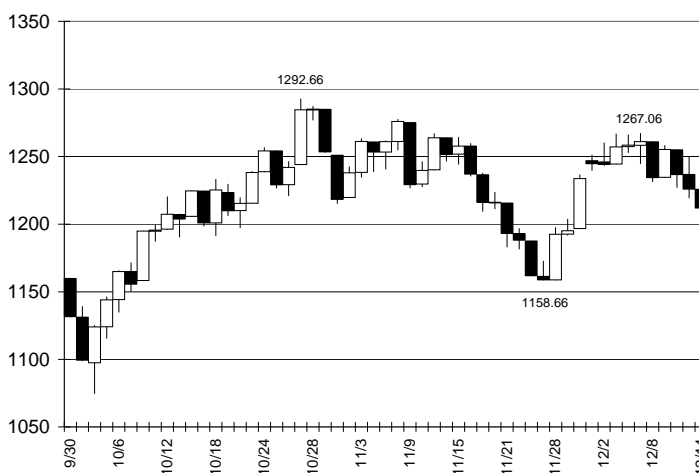
I had previously suggested that the November 25 low qualifies as a successful retest. The key now will be to see whether the market holds above this level, if it is in fact heading lower near-term.

We can then be more optimistic, if the market pushes above its December 7 and October 27 interim highs to establish a new pattern of higher highs and higher lows. Until then, we may be range bound.

The latest bout of pessimism stems from the failure of the European Union to get unanimity on its proposed treaty change that would impose greater fiscal discipline upon the 17 countries that use the Euro. The United Kingdom was the one hold out. Prime Minister David Cameron tried to cut a deal to protect London's position as a global financial center in exchange for his country's consent. This negotiating play was

Chart 1

S&P 500 Daily Price Action: Sept. to Dec. 2011



rejected by other EU members, most notably France. So the EU put on its happiest face. EU leaders suggested that it could proceed anyway, bypassing a treaty change and adopting an agreement among the rest of the countries. This would be a quicker solution, but one that also would be subject to legal challenges.

Since rejecting the treaty proposal, Mr. Cameron has come under increasing fire, which prompted him to express support for the UK's membership in the EU. At the same time, as the stock market has begun to sink lower, the sovereign debt and short-term money markets have become increasingly nervous. Thus, both sides are feeling the heat to get unanimity on the proposed treaty changes. It is therefore possible that Mr. Cameron and the rest of the EU could come to terms, which would make the markets happy once again.

In the meantime, however, financial markets are also reacting to the likelihood of slower than anticipated economic growth in 2012.

Many economists believe that the EU is already in recession. Emerging market countries, including China, India and Brazil, are struggling with reduced demand for their exports. The lone bright spot seemingly has been the U.S., where the economic data suggests that things are not quite as bad as feared just a couple of months ago. Still, the pace of economic expansion is far below what was anticipated a year ago.

Commodity prices, with the curious exception of oil, are also signaling a slowdown ahead. Yet I think that it is important to recognize that confidence plays a big role here. A pick-up in confidence could move the growth needle more positively in the weeks ahead.

General Electric (GE)

More Confident in Its 2012 Outlook

GE remains a bellwether of the economy and the stock market. Yet, it is somewhat surprising that its stock price has struggled all year, falling 10.2% through Dec. 13, compared with a 2.5% decline in the S&P 500.

This weakness has prevailed despite management's increasingly upbeat tone. While the broader economy has been struggling, GE has shown improvement. The company anticipates closing out 2011 with a double-digit percentage earnings gain and expects a similar increase in 2012. It has also raised its dividend twice this year - the latest by \$0.02 to \$0.17 per quarter, giving the stock a 4.1% dividend yield.

GE's resurgence has been driven in part by GE Capital (GECC). This business, which ranks as one of the largest U.S. banks serving mostly small and medium-sized enterprises, saw its profits fall from a 2006 peak of \$10.7 billion to \$1.6 billion in 2009. Losses on commercial real estate investments sparked most of that decline; but so far this year, the Real Estate division has chopped its operating loss in half and will likely post a profit in 2012. Lower losses in Real Estate combined with improved profitability in all of its other businesses will lift GECC's profits from \$2.3 billion in 2010 to a projected \$6.5 billion in 2011. With higher earnings expected in 2012, GECC hopes to pay a dividend of around \$1 billion to GE, the first such payment since 2008.

In its industrial businesses, GE is positioned to continue to deliver overall double-digit earnings growth, even in a modestly weak or volatile global economic environment. The company is benefiting from strategic steps taken (i.e. acquisitions) to bolster its presence in growth businesses, such as oilfield services, while trading out of businesses with less favorable growth prospects, such as media and plastics. New product development will help to accelerate growth in niche segments, such as engines for narrow body airplanes. GE has also infused its new products with the latest technology to improve performance and productivity for both its customers and its service teams. It has built its order book by aggressively pursuing new business in emerging markets, such as Brazil, Russia, India and China, in part with products designed especially for those markets. The company's strong efforts to grow revenues is also matched by a steady focus on reducing operating costs.

Management acknowledges that GE faces several potentially significant headwinds: including the spillover effects of financial market turmoil in Europe, regulatory uncertainty, potential budget cuts in the U.S. and elsewhere and ongoing weakness in housing; but it has built in cash and cost buffers which it believes can help offset these headwinds in all but the most extreme scenarios.

GE Valuation Metrics

Recent price	\$	16.61	
52-week range	\$	14.02	- \$ 21.65
Dividend	\$	0.68	
Yield		4.1%	
Dividend payout		55.3%	
Shares outstanding		10,557	millions
Market cap.		176,072	millions
		EPS	PE
ttm - cont. op. (GAAP)		1.23	13.5
ttm - operating		1.33	12.5
2011E		1.37	12.1
2012E		1.56	10.6
		Per Share	Multiple
Free cash flow	\$	0.84	19.8
Book value	\$	11.79	1.4
Tangible book	\$	10.61	1.6
Sales (ttm)	\$	14.32	1.2

Beyond that, the company's key long-term challenges are GECC and Healthcare. Despite the improvement in GECC, it is not clear whether that business will be able to deliver that an acceptable long-term return on investment, now that it is regulated by the Federal Reserve. For now, GECC will hold its ENI or "ending net investment" at \$440 billion and seek to improve returns by replacing low return financial assets with higher return ones. GE's Healthcare business, meanwhile, will eventually feel the pinch from efforts around the globe to reign in runaway costs, even if Obama's individual mandate is deemed unconstitutional by the U.S. Supreme Court.

I previously raised my bet on GE back in mid-September with the addition of 500 shares at \$15.79. Since then, the stock has risen by 5.2%, better than the S&P 500's overall gain of 2%. GE's dividend yield of 4.1% is attractive. If the company delivers on its double-digit earnings growth guidance for 2012, I believe that the stock has the potential to reach \$21, a 26% gain from the current level. If so, the dividend will likely see another decent increase, keeping its yield well above 3%.

For more than five years now, I have also held a modest position in GE Interest Plus Notes, a short-term deposit-like investment offered through GECC, which currently pays 1.11%, better than a typical money market fund and most CDs. GECC is now making a big push to source deposits over the internet. I will hold this position for now, as long as the rate remains attractive on a risk-adjusted basis.

The Energy Sector

Rough Going for Energy Stocks

The performance of the energy sector has been one of the many surprises in the stock market recently. Over the past six months, while the S&P 500 has fallen 4.3%, the S&P 500 Energy Sector has fallen 7.5%.

OK, so that does not seem like that much of a difference; but when you dig deeper, you find that the shares of large cap, major integrated oil companies (e.g. ExxonMobil, Chevron, ConocoPhillips, BP, Royal Dutch Shell, etc.) are roughly flat over that time frame; while most of the smaller independents are down 10% to as much as 30%.

So what might explain that difference in performance? Well, for one thing, the price of oil has fallen from just over \$99 in mid-June to about \$95 currently, a decline of 4.4%. Natural gas has plunged 31% from about \$4.60 to around \$3.20. Perhaps the simplest explanation is that the production of the majors tends to be more heavily weighted toward oil, while the independents focus more on natural gas. So, ignoring the effects of hedging, a natgas driven independent may be staring at a 30% drop in earnings.

The majors may also be more favored because they generally offer attractive dividend yields, usually 3%-5%, and dividend stocks are hot right now.

Further digging complicates the picture. Why did the price of oil rallied from \$76 per barrel in early October to a peak of around \$103 in mid-November? True, the advance coincided with the stock market's rebound, so investors were feeling better about the economic outlook (and the demand for oil). But until yesterday, the price of oil remained high even as the stock market gave back some of those gains.

And if the economic outlook has indeed brightened, why has the price of natural gas continued to fall? Obviously, supply issues also play a role in price determination. Global oil supplies are generally seen as tighter (relative to global demand) than natural gas supplies, which are locally driven and rising fast because of the initial success of hydraulic fracturing.

Yet, the financial markets have also seemingly ignored the action taken last week by the EPA that effectively blamed fracking techniques used by Encana for the pollution of groundwater in Wyoming. It is apparently difficult to prove conclusively that fracking is the cause of higher than acceptable concentrations of chemicals and gases in water, but the facts in this case provide the clearest ability to link cause and effect. Still, Encana disputes the EPA's findings.

I don't believe that this is the end of the issue. I expect that EPA will file more charges eventually and if the industry does not address its concerns, there will ultimately be a movement to curtail the use of fracking. For what

it's worth, the technique is banned in France. It is also not clear to me that fracking results in the highest level of resource recovery, which may be a bigger issue going forward. For now, I will hold on to my "frackers" but remain watchful.

My strategy for investing in the energy sector has been to try to pick companies that are less exposed to the risks facing the industry, most notably geopolitical risk, but also other operational risks. This may turn out to be a good strategy in the long-run, but in 2011, my energy picks have generally underperformed the sector and the overall market.

Imperial Oil (IMO): This is Canada's largest integrated oil producer. 70% of its shares are owned by ExxonMobil. The company has a very large position in the Athabasca oil sands, an unconventional resource play that is second only to Saudi Arabia's reserves in size. Imperial's Kearl Sands project is expected to begin operating in late 2012 and add 25% or 110,000 barrels (and eventually up to 345,000 barrels) to IMO's daily production levels.

In the near-term, IMO's production outlook has been clouded by the controversy over the Keystone XL pipeline; but if the U.S. fails to approve it, the oil may be shipped to Canada's west coast for export to China.

IMO's stock is down 10% since mid-June, underperforming both its peers (including its parent, XOM) and the broader market. The stock has performed poorly, despite very strong operating results over the past couple of quarters. Unless IMO's production is curtailed due to environmental or political reasons, it should have better than average upside potential in the years ahead.

Cimarex Energy (XEC): A long-term holding, this Denver-based independent power producer has grown steadily in recent years through acquisitions and the organic expansion of its drilling operations. Fracking techniques have helped boost its production of natural gas and, more recently, of oil in the Texas Permian basin. The company has been transitioning its production away from the Gulf Coast and more toward its Mid-Continent and Permian plays. As a result, it has had difficulty growing overall production in 2011, which along with the drop in natural gas prices has weighed heavily on the stock. I sold half of my position when the stock surged above \$100 per share last May, but bought back the same number of shares in August, after it had fallen back to \$68. Its share price is down 30% since mid-June and also down 10% since my September purchase. At the current price around \$60, I believe that it is a good value, but it will take a boost in production levels and higher natural gas prices for the stock to regain the ground that it lost.

(Continued from page 3)

Enerplus Corporation (ERF): I added this position (and also PWE) in mid-June, looking for dividend income with some modest growth potential. ERF was a Canadian royalty trust (whose tax advantages were stripped away by the Canadian government). Yet, it has maintained its monthly dividend of \$0.18 per share (which translates into an 8.8% yield at the current share price). This is obviously attractive, but the cost of the dividend plus capital expenditures significantly exceeds the cash flow that the company generates from operations. Consequently, ERF must grow at a fairly rapid clip in order to sustain its dividend. For now, it looks like it has sufficient resources to sustain the dividend for a while. The company has a stable operating base in Canada, with growth potential in its positions in the Bakken/Three Forks play in North Dakota and in the Marcellus shale. In the third quarter, poor weather conditions in North Dakota impeded the completion of a number of wells. The company believes that it will make up for those delays in the fourth quarter, so that its ending production rate will be close to its original guidance. This is important, because any further delays will likely sustain the net cash outflow and therefore put the dividend at greater risk. The stock is up off of its lows but still down from my original purchase price of \$30 to about \$24 recently. Its chart does not look great at the moment. I will look to exit my position, if the stock breaks below its Oct. 4 low of \$21.21.

PennWest Petroleum (PWE): Another former Canadian Trust, PWE has fallen in price from my mid-June entry point of just over \$22 to just under \$18 recently. It pays a quarterly dividend of \$0.27 per share, good for a 5.8% dividend yield at the current quote. Unlike ERF, PWE has previously cut its dividend to bring it more in line with its current cash flow generating potential. The company has strong positions in the five leading light oil producing regions in Canada. It has benefited in recent years by applying horizontal multi-stage technology (i.e. fracking) to its resource base, which will enable it to increase the proportion of its light oil production to 51% of the total by year-end 2011 (from 39% at the beginning of 2010). Likewise, PWE will increase its liquids production to 66% in 2011 from 57% in 2010. (Oil and natural gas liquids carry much higher prices currently than natural gas, so the shift will help boost PWE's profitability.) Like ERF, it is paying out more for dividends and capital expenditures than it is currently generating from operating activities. However, the cash flow short fall is not nearly as great. Although the stock is down 20% or so from my mid-June entry point, the chart here looks more promising near term.

Action This Issue

Although I am taking no action in this issue, I believe that all of these stocks have good, near-term upside potential, assuming that the economic recovery continues.

STOCKS Company	Ticker	Action	Existing Shares	New Shares	Recent Price (12/14/11)	Safety Rating	Performance Rating
Cimarex Energy	XEC	Hold	200	0	\$60.05	C-	2
Enerplus Corporation	ERF	Hold	200	0	23.75	D	2
General Electric	GE	Hold	1,000	0	16.61	C	1
Imperial Oil	IMO	Hold	300	0	40.82	B	2
Penn West Petroleum	PWE	Hold	300	0	17.84	C	2

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