

## Economic & Market Commentary

For a year in which pessimism was more common than optimism, financial assets were treated kindly in 2010. Stocks produced double digit returns, with the S&P 500 up 15% and the Russell 2000 Small-cap index up 26%. Most bonds (except municipals) produced positive returns in the mid-single to low-double digit range. During this second year of recovery, worries and hand wringing were more common than cheering. U.S. political risk, fears of heightened business regulations and China slowing were on investors' minds from the outset. Then two larger concerns emerged in the form of fears of European sovereign debt problems in the spring, and weakening domestic economic conditions during the summer, increasing the risk of a double dip in our economy. One market pundit refers to 2010 as the "Year of Doubt" and, in fact, until early September the S&P 500 was in negative territory. It wasn't until late August, after Fed Chairman Bernanke's speech indicating the monetary authorities would "do whatever it takes" to keep the U.S. economic recovery intact, that the stock market began to respond positively. Macro conditions called the tune for most of the year and volatility for all classes of financial assets increased. Indicative of this was the fact that we had 8 moves of  $\pm$  5-15% in stocks during the year, capped by the final move of close to 20% after Chairman Bernanke's speech and the announcement of QE2. The month of December alone produced about half the year's appreciation in the S&P 500. This volatility made managing portfolios more difficult than usual. Each move, be it up or down depending on the economic news reported, had its own over and under performing sectors of the market. With strong economic news you were rewarded for owning risk, and with weak news you were penalized. This back and forth circumstance made picking stocks and establishing strategy very difficult.

At the onset of 2010 we said that our best guess for the year would be subdued growth, accompanied by mixed signals – some positive, some negative - making for a volatile market. That is, in fact, what happened. The U.S. economy will end the year with real growth of about 2.8%, (after a stronger Q1 (+3.7%) and a weaker Q2 (+1.7%), we have plateaued at (+2.6-2.7%)). The composition of this growth was slightly different than we expected at the beginning of the year. As we wrote earlier, the strength of the consumer, in the face of all the known problems, has been surprising. The average consumer has had to contend with a myriad of issues:

- 10% unemployment, with in reality close to 15% of the labor force not working. In addition close to 40 million Americans are receiving food stamps, a staggering number
- An overleveraged balance sheet which won't be mended for some time
- A decline in housing prices, that may have more to go, leading to unprecedented mortgage delinquencies and defaults
- Confidence levels that are hardly robust and personal bankruptcies that have accelerated

Yet the consumer continued to spend and has been a significant contributor to GDP growth over the year. The rally in financial assets and the stabilization in housing prices helped the consumer's balance sheet, and the growth in transfer payments helped the income statement, providing incentive to spend.

Business did its part as inventory rebuilding and capital spending contributed to growth about as we expected. On the other hand, exports did not help as we thought they would. Net exports were a drag as imports exceed exports. The other components of GDP growth – construction and government - performed about as we had expected.

Like our subdued views on the economy, we expected modest gains in financial assets last year, and would have been happy with a single digit return. So the actual results were a pleasant surprise. The “Bernanke put” and the November election, leading to more certainty on taxes (albeit only for 2 years) and the hope that business bashing and increased regulation would diminish, changed the tone.

As we turn the calendar to 2011 we are as close to a sustainable recovery as we have been since the downturn began in 2007. The policy actions of the past several months have bought time, and positive natural forces are beginning to emerge. The employment situation is slowly improving, although monthly job creation is far from the level necessary to make a dent in the unemployment rate (estimated to be 150,000/month). We expect employment to show steady improvement over the course of the year. This in turn will allow the consumer to continue spending. Employment growth, stabilization in the housing market, and continued decent performance from financial assets are necessary to offset an eventual decline in transfer payments, to maintain consumer confidence, and offset the continuing deleveraging of household balance sheets. In addition the average consumer will have to contend with rising prices in a basket of daily purchases. While the policymakers focus on “core” inflation, which excludes food and energy, the average person has to eat, drive, and heat a home, and is not immune from rising food commodity and fuel costs. These items have clearly increased, and “headline” inflation will reflect this.

On the corporate front, capital spending (largely on productivity enhancing projects) has been modestly positive so far, and we expect that to strengthen. Inventory rebuilding has been a strong factor; however that should subside over the course of the year. Exports have been strong, but imports have been stronger. We would hope that net exports become a positive during the year. The housing sector was a drag on GDP growth last year, we would expect it to be less so in 2011.

These factors should be enough to allow domestic real GDP to advance close to 3% for the year, slightly more than is expected for 2010. A survey (of 67 Wall Street and academic economists) by Bloomberg in early December found that the median growth expectation for 2011 was + 2.6%, with the outliers at +1.5%/+4.0%. Since that survey, most economists have raised their forecasts, with many projecting growth greater than 3% for the US, and close to 5% for the world (led by emerging markets +7.5%). These circumstances do not alter the view we have had for most of the past year that we will have slow and probably below trend growth for the next several years. Even if all goes well, we will still have the deleveraging process in both the public and private sectors to contend with. Reducing leverage takes time, and exacts a toll. More often that not that toll will reduce growth.

As has been the case all year, corporate profitability has been the highlight in the economic outlook. Once again we are in the earnings reporting season and the final quarter should be a

good one – estimates are for operating earnings of +30% compared to a year ago. Profit margins are close to all time highs. Earnings estimates have been raised since the last quarter. The consensus view appears to be that the S&P 500 will report operating earnings close to \$85 for 2010, and \$95 for 2011. Our original inclination was to think a \$95 estimate for the current year was too aggressive. Our reasoning went as follows:

- +3% real GDP +2% inflation = 5 % nominal GDP
- GDP to S&P revenues - +4% = + 9% revenue growth
- Margins close to highs = no change

These assumptions yield earnings of \$92-\$93. With financial stocks being the wild cards, \$95 is not unreasonable. Therefore, at year end, the S&P 500 was selling close to 15 times 2010 earnings and close to 13 times 2011 estimates. This is not expensive, but neither is it cheap. A simple discounted earnings and dividend model we use puts the fair value for the S&P at 1250 – about where it closed the year.

In spite of turning the calendar, and noting the positives that have taken place in the past 4 months, much of the investment world looks similar to the beginning of last year. Granted stocks are higher, but bonds are not far off year ago yields, economic forecasts are not far apart, and inflation still is benign but increasing. Most importantly many of the risks are the same, and there have been a few new ones added to the list.

- Euroland is still a mess with no real definition of how to get Greece, Portugal, and others righted
- Deleveraging is still a world issue with at least 4 European countries with debt to GDP ratios close to or exceeding 100%
- The US deficit continues to grow with little sign of action to tackle the problem with its inflationary and currency consequences
- China's pace of growth and inflationary potential continues to be a question
- Public sector finance issues have spread beyond the federal government to many state and local governments
- Housing is still a question mark and values could decline further creating pressure on banks and households

These are issues that seem to have been forgotten in the latest market rally, yet could very well have a major impact on the coming year. The talking heads and many Wall St. strategists have adopted an increasingly bullish stance over the past few months, and seem, to be ignoring these issues. With most bullish, it makes us feel uneasy. Our assumption for the past few months has been financial markets would be hospitable through midyear, as many of the policy measures of the past few months worked through the system. We still believe that is a likely outcome, but much of it may have already been discounted. This makes setting investment policy more difficult, but we feel the weight of evidence argues for maintaining our earlier posture and remaining positive. The risks demand constant attention, but we probably have until mid-year to gain clarity. The good

news from an equity investor's perspective is that valuations among stocks are still compressed, corporate balance sheets are still strong, and high quality businesses, selling at reasonable prices, are still available.

### *Fixed Income Review and Outlook*

2010 was a volatile year for fixed income investors that once again rewarded risk and duration. However, if investors were not full year participants in the market, they could have experienced periods of significant underperformance. For example, the yield on 10 year Treasury bonds climbed as high as 4% and fell as low as 2.38% during the year. From November to the end of 2010, yields on 5 year Treasury bonds doubled from 1% to 2%. Finally, long Treasury investors saw gains of 20% and losses of 17% during short periods of 2010. This represents extreme volatility for the fixed income market, an unusual occurrence. Most fixed income markets performed reasonably well for the year, with some, including low rated corporate bonds and commercial mortgage backed securities generating outstanding returns.

The year began with the expectation that the Federal Reserve would begin to remove some of the financial stimulus introduced earlier through the purchase of government securities (quantitative easing). Rates climbed to their highs for the year toward the end of the first quarter, in anticipation of the end of Fed activity and the shrinkage of its balance sheet.

The middle of the year was dominated by events in Europe and US economic data that called into question the strength of the recovery. Investors sought the safety of Treasuries as a defense against both of the conditions and Treasuries rallied into the third quarter. Short and intermediate interest rates reached their 2010 lows in October.

Concerns about Europe, deflation, and persistent unemployment in the US caused the Federal Reserve to introduce another bond purchase program to try to stimulate the economy. This second round of quantitative easing, or QE2, was announced in early November. The near term results of this announcement were not what the Fed anticipated. Concerns about the potential risks of inflation from this program drove interest rates off their lows for the year.

While this increase in yields negatively impacted fixed income returns in November and December, full year returns for all types of bonds were positive in 2010. According to Barclays Capital, Treasuries returned 5.87%, government agencies returned 4.56%, corporate bonds returned 9%, and mortgage backed securities returned 5.37%. Some less general classes within fixed income generated even higher returns. For example, long maturity Treasury bonds returned 9.38%, Baa-rated corporate bonds returned 10.9%, and commercial mortgage backed securities generated a remarkable 20.4% return. Finally, even the much maligned municipal bond market provided investors with positive returns last year with The Barclays Municipal Bond Index up 2.38%.

For the coming year, we believe that investors will experience very low inflation, slightly higher yields, slightly wider corporate bond spreads, and at least one market rally during the year similar to that of the second and third quarters of 2010. As noted, the economy looks to be moving in a positive direction, albeit slowly. This should serve as a catalyst for higher interest rates. The

expectation of higher rates will likely encourage corporations to issue debt to lock in lower rates. This increased issuance will likely push corporate bond spreads wider as investors should require higher yields to absorb the new bond supply. In the mortgage sector, we expect a flat to slightly down housing market. This will be modestly positive for mortgage investors as foreclosure fears are not likely to weigh on the market in 2011. Higher rates should also slow prepayments, which will enable mortgage investors to earn their expected yields for a longer period of time. Finally, we expect the municipal bond market to provide opportunities for above market returns in 2011 as concerns of extensive state and local defaults should prove to be without merit.

What could derail our forecast? The flight to quality trade was alive and well during the second and third quarters of 2010. We may experience that again as the US economy improves gradually and certain non-US economies (especially those of peripheral Europe) struggle. In spite of attempts from certain nations to derail the US dollar as the world's reserve currency, 2010 proved once again that the dollar is the place to go when the going gets tough. This could occur again in 2011. China is a wild card for fixed income investors in the US. Its massive holdings of US debt give it unique leverage over the US. However, China's decision to peg its currency, the yuan, to the dollar combined with its massive trade exposure to the US reduce the probability of China taking economic action against the US by selling bonds.

Finally, while we expect few if any municipal defaults in 2011, a large, unexpected bankruptcy from a major US city or county (states by law cannot file for bankruptcy) could disrupt not only the municipal market but some of the peripheral fixed income markets as well.