Q4 2010

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INVESTMENT *perspective*

Financial markets in 2010 were driven primarily by continued extraordinary measures implemented by policy makers around the world to support the nascent economic recovery and to preempt a potentially debilitating deflationary spiral. Foremost among the various policy actions were the European Union's rescue fund to allay fears over a European sovereign debt crisis, the Federal Reserve's Quantitative Easing II program which entails the expected purchase of an additional $600 billion of Treasury securities through June 2011, and the unexpected year-end tax compromise which is estimated to provide stimulus of $590 billion in 2011 and an additional $270 billion in subsequent years by postponing an increase in tax rates.

This huge collective stimulus together with very low returns on risk-free assets prodded investors toward equities, commodities, and other risk assets. The S&P 500 Index advanced 10.8% in the fourth quarter and rose 15.1% for the year. Smaller capitalization stocks outperformed larger capitalization stocks, and the Russell 2000 Value Index was up 24.5% in 2011.

Bond investors in the latter part of the year were negatively impacted by rising interest rates as economic fundamentals improved and the surprise tax deal sparked higher future growth expectations. The Barclay's Capital Aggregate Index declined 1.3% during the fourth quarter, but returned 6.5% for the year as interest rates of longer maturities actually declined from the beginning of 2010.

The second half trends of 2010 are likely to continue in the first part of 2011. The policy actions implemented last year, particularly those in the U.S., have had their intended impact of boosting economic activity and raising most asset prices, and the "negative feedback loop" of late 2008 and early 2009 is in the process of being reversed.

Almost all economic data has shown improving trends over the past several months, with the notable exception of the housing sector which continues to suffer from a huge supply overhang. On the positive side, consumer spending has rebounded with year-over-year same store sales as measured by the leading retail sales survey up 5.4% in November followed by a weather-impacted rise of 3.1% in December. Sales for the traditional two-month holiday season were the highest since 2006. In addition to increases in households' net worth due to rising equity markets, consumer sales have been supported by an increase in personal income of 3.8% year-over-year in 2010 as compared to a decline of 2.2% at the end of 2009. The non-manufacturing Inventory Sales Management (ISM) Index which gauges industrial production was 57.1 in December, stronger than expected and up from November's level of 55.0, indicating growing momentum in the economy. The year also ended on a positive note for auto manufacturers, including the long suffering U.S. automakers, with total sales up 11% in December from one year ago, thus prompting estimates of projected sales growth in 2011 to be raised to over 16%. The 2% reduction in the Social Security tax which was part of the tax deal should provide some additional support for consumer spending in 2011.

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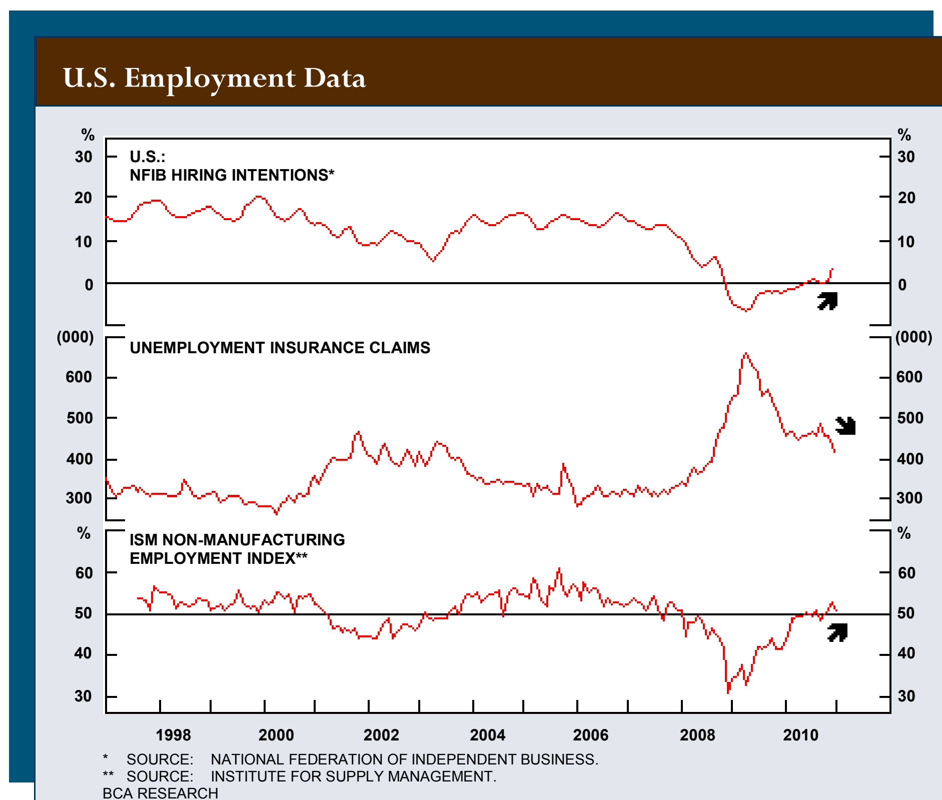
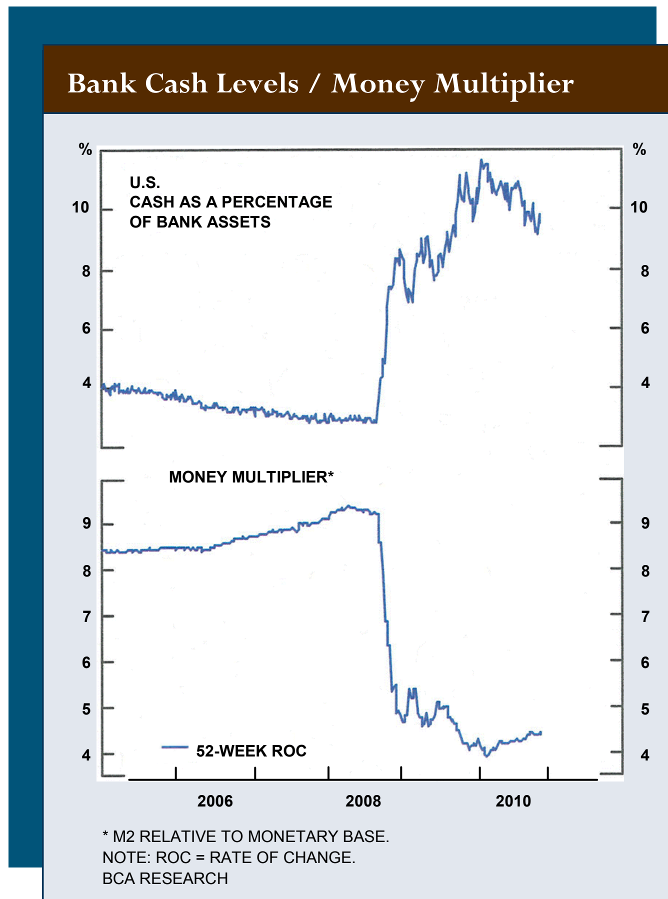
The trend has been improving in the U.S. job market, albeit slowly. Approximately eight million jobs were lost in the "great recession," and while the bulk of the layoffs stopped in 2010, only 1.1 million jobs were created last year due to high levels of uncertainty in demand levels. Encouragingly, the National Federation of Independent Business which supports small companies reported in December that its members had positive hiring intentions for the first time since 2008. December's payroll report of 103,000 net jobs created in the month was less than expected, but together with positive revisions made to October and November, the total number of new jobs were in line with analysts' estimates. The unemployment rate dropped to 9.4% due both to the increase in employment and a reduction in the labor force. While the trend is positive, the difficult reality for many of the unemployed is that structural changes in the economy along with an improving, yet modest economic recovery by historical standards will result in elevated levels of unemployment for many years.



One major headwind which will continue to restrain the economic expansion is the ongoing deleveraging of the consumer. Ultimately, this is a very positive development as savings rates in the 5% - 6% range provide critical capital for productivity enhancements and future growth, but in the short term it limits consumer spending which accounts for the largest part of the economy. The U.S. household debt-to-income ratio which peaked several years ago at approximately 1.4 times has decreased to 1.2 times, but still has a long way and potentially many years to go to reach more desirable levels.

While the near-term trends in the economy and continuing stimulative monetary and fiscal policies are supportive of equity markets, at some point there will be significant consequences for the level of public debt being created. The most serious concern is a sharp increase in inflation, yet this problem could be a year or more delayed given ongoing deflationary global trends and limited domestic credit expansion. Healthy corporations have significant excess cash holdings and very limited borrowing needs, and banks' higher credit standards have resulted in record levels of cash as a percentage of U.S. bank assets. The net result is an anemic "money multiplier" and few inflationary pressures building in spite of the large stimulus. We monitor very closely various measures of lending activity to detect any change in this key determinate of economic activity.

Bank Cash Levels / Money Multiplier



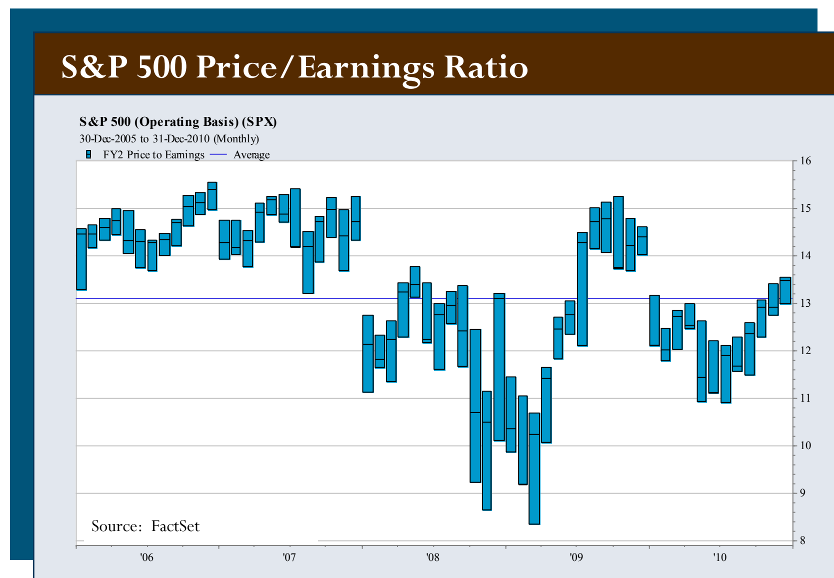
* M2 RELATIVE TO MONETARY BASE.
NOTE: ROC = RATE OF CHANGE.
BCA RESEARCH

Equities have also been boosted by strong growth in corporate profits. After-tax U.S. corporate profits have fully recouped their sharp decline in 2008-2009 and have surpassed the peak profit levels reached in 2006. Corporations have achieved this profit growth through strict expense management and higher productivity levels. One of the possible concerns we have going forward is whether current high profit margins can be sustained. Our working assumption is that moderate economic expansion in the 3+% range for real GDP will result in positive profit growth. However, companies are running quite lean, and the ability to maintain margins in any unexpected downturn would appear to be limited.

Most unpleasant memories have a tendency to fade, but we clearly remember the swift market decline last May and June related to the "flash crash" and the financial crisis in Greece. Regarding the flash crash, the lesson learned is that in highly uncertain investment environments, investor sentiment can and will shift violently. The European sovereign debt problems and their possible impact on a full fledged European banking crisis is a key ongoing concern. The European Central Bank has successfully bought time for the struggling "peripheral" countries, but the structural problems of excessive debt, deteriorating demographic trends and the underlying lack of competiveness of many European countries have only been "kicked down the road." The same can be said of the continuing imbalances in the U.S. The financial markets will at some point reject unsustainable debt levels and will force discipline among policymakers. Until global public deficits reach sustainable levels the macroeconomic risk environment will remain highly uncertain with the potential to severely impact equity markets in a short period of time, and we are as always monitoring those risks closely.

Conclusion on back …

In summary, we are positive on equities especially in the first half of the year given the continuing positive trends, and valuations, while no longer cheap, are reasonable. Given the significant rise in equity and commodity prices that have occurred since the end of the second quarter, however, the equity markets may consolidate recent gains as investors await first quarter 2011 guidance. We remain focused on companies with strong or improving balance sheets and returns on capital, and companies with attractive customer value propositions which can deploy capital productively and efficiently. In addition, we are investing in companies which should benefit from increased liquidity flowing into the economy.



We expect that interest rates will be modestly higher at the end of 2011, and that corporate bonds should once again outperform Treasuries as conditions continue to be supportive for risk assets. In 2010, the Investment Grade credit index was up 8.5% versus the Treasury index which was up 5.9%. Within the credit sector, the lowest investment grade issuers (BBB) outperformed A-rated issuers by 140 basis points. We have structured our taxable portfolios with shorter durations and are significantly underweight the Treasury sector, and believe our portfolios can achieve positive returns with modestly rising interest rates.

Municipal bond yields rose along with Treasury yields last year. Additionally, some municipalities are facing significant financial troubles, and the municipal sector will be subject to headline risk as states and cities grapple with unfunded pensions and closing large budget deficits. We are not expecting any significant credit deterioration in the single A or higher rated municipal bonds we invest in. Historical default rates remain at .0028% of the market with the majority of those very few defaults occurring in non-rated, special purpose issuers. We see the recent backup in municipal yields as a buying opportunity, and we are focusing our research on high quality issues in the 3-7 year maturity range.

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