2010 Year in Review

2010 was about before September and then the rest of the year. Before September, the world markets were on a roller coaster ride, with large brief rallies followed by large declines, all the while not managing to go much of anywhere. Macro factors weighed on global markets including the European debt crisis, US unemployment, and double dip recession fears, all of which added uncertainty to the economic outlook and toyed with investor confidence. It all seemed to turn on a dime in late August when Ben Bernanke implied that the Fed would engage in Round II of its Quantitative Easing monetary policy. From there, it was off to the races into year-end, proving yet again that it is foolish in the short run to fight the Fed. Through August 31st, the S&P 500 was down 4.7% but over the last four months of 2010 the S&P 500 returned 20.7% to end the year up 15.1%.

Two other important events occurred late in the year that also spurred the stock market higher. The first event was the November election, a landslide win for Republicans and a repudiation of the Obama administration and its policies from a very angry electorate. Republicans made massive gains in the House and picked up a large number of seats in the Senate and many state legislative bodies saw large swings towards Republicans. The prospect of a more balanced policy approach increased investor confidence in the forward outlook. The second event was the deal cut between Obama and Republicans on the extension of Bush tax rates for two years. While Obama campaigned for higher tax rates on wealthier Americans, the current economic reality and new political landscape forced him to compromise. The prospect of tax rates going higher next year was also viewed as a major headwind to growth for 2011 and once the deal was signed, 2011 GDP forecasts were revised higher. The stock market always looks positively upon higher rates of GDP growth. At what cost remains something to worry about in the future.

In last year's Investment Outlook, I thought a best-case scenario for the US stock market as measured by the S&P 500 could trade to 1230 level by year-end 2010. The S&P 500 finished 2010 at 1258 , returned 15.1% for the year and performed better than I expected. But mostly for the wrong reasons. Through the end of August, things were not looking quite so optimistic All of the return for the year was generated in the last four months of the year and primarily due more to monetary policy, tax policy, and political related news events. From a fundamental perspective, corporate profits were better than expected in 2010. At the beginning of the year, 2010 S&P 500 earnings were estimated to be $77/sh and they will likely be closer to $86/sh. So, from a fundamental basis, the earnings outlook was 10% better than expected and on its own merits would have lead to a positive return for the stock market. The other factors added fuel to the fire.

Here is where we started and finished the year on a few key market stats:

	12/31/09	12/31/10
S&P 500	1114	1258
10 Year US Treasury Yield	3.83%	3.29%
Gold/ounce	1096.20	1421.40
Oil/barrel	$79.36	$91.38
Eur/USD FX Rate	1.43	1.34

With the Fed retaining its near zero interest rate policy and adding a second round of Quantitative Easing, risky assets were the place to earn the highest returns for the second straight year. The S&P 500 returned +15.1% for the year and the small cap segment of the stock market as measured by the Russell 2000 Index did much better, returning 26.8%. S&P sector leaders remained the more cyclically biased sectors as Consumer Discretionary (+28%), Industrials (+27%), and Materials (+23%) handily outperformed while the more defensive sector laggards were Healthcare (+4%) and Utilities (+6%). Growth stocks modestly outperformed Value style indices with the Russell 1000 Growth Index returning 16.7% while the Russell 1000 Value Index returned 15.5%. Commodities and precious metals were the biggest winners in 2010 as the price of oil, gold, silver, corn, soybeans, and cotton all soared.

On the international front, riskier assets such as emerging markets continued to do well with the MSCI EM Index returning 16.4%. Despite all the focus on China, it was one the worst performing markets during 2010, returning 1.0%. Developed international markets did worse than US markets, mostly due to caution over the potential impact on GDP growth of the sovereign debt situation in Europe. The MSCI EAFE Index returned 4.9% for the year. Europe was the worse performing region in the world, returning 1.0%.

On the fixed income side, bonds were having another strong year through the end of August. US Treasuries were benefiting as the European sovereign debt issue worsened and investors sought out the relative safety (not quality) of US debt. By August, the 10-year US Treasury yield declined to a low of 2.33%. Then began a massive rotation towards stocks starting in September and bonds hit a wall. Bonds still managed to have a solid year, but ended well off the height of returns earned through late summer. In particulate, US Treasury securities had a large sell-off into year-end as the extension of the Bush era tax cuts added to worries about the already significant levels of US federal debt. The corporate bond market had another strong year as the profit outlook improved throughout the year. The riskier high yield bond segment, as measured by the Barclays HY Index, returned 15.1% as they typically benefit from similar trends in the stock market. Higher quality corporate bonds were also solid performers, with the Barclays Intermediate Term Investment Credit Index returning 10.5%. The broad US fixed income index, the Barclays Aggregate Bond Index, returned 6.5%, held back by the lagging performance of US Treasury bonds late in the year. Given the Fed maintaining a low interest rate policy, cash and money market investments returned virtually nothing all year. The 3-month Treasury bill, a proxy for cash, returned 0.2% for the year.

2011 Investment Outlook – Stay On Your Toes

The key to successful investing is managing risk. Humans are hard wired to focus on return (how much can I make?) but rarely focus on the risk taken (potential loss) to earn the return. Howard Marks of Oaktree Capital Management has written some thoughtful pieces regarding the risks associated with investing and believes there are two main risks in the investment world. The risk of losing money and the risk of missed opportunity. Investors can avoid one or the other, compromise between the two, but never eliminate both. At the extremes, humans typically obsess about the wrong one.

At the end of 2008, it felt like the world was coming to an end and by March 2009 most people were convinced that was the case. The risk of losing money was considered very high, investors were scared, and many sold their investments and moved into cash to avoid further losses. They became obsessed with the risk of losing money. As we now know, March 2009 marked the bottom of this current stock market cycle. In retrospect (the ultimate means of clarity and wisdom), the risk of losing money was high and the risk of opportunity was low as the market was discounting extreme risks and investor sentiment was at depressed levels. Investors that assumed more opportunity risk at that time have been handsomely rewarded as the S&P 500 is now up 90% from the March 2009 low. If you managed to stay the course and stayed invested into the market lows of March 2009, your investment balances look much better today, even if they are still not back to where they were in 2007.

2009 and 2010 have been two years of very strong stock market performance, especially for riskier assets. If you look at the annual returns of the S&P 500 Index for the last two years (27% in 2009 and 15% in 2010), on the surface it appears we are in an economy doing quite well. As we all know, the economic reality of today is much more sobering. While the annual returns the past two years are nice, the underlying story of the returns earned over the last two years paints a much different picture. It has been HARD going to earn those returns and one had to tolerate a high degree of volatility to get there.

Which brings me to my key point for my 2011 Outlook. As a result of the market rally since March 2009, we are now at a point in time where the balance between the risk of losing money and the risk of missed opportunity is at a crucial stage. Do you continue to ride the current market momentum and take on the risk of opportunity, or is it time to place more emphasis again on the risk of losing money. One or the other, or a balance between the two? That is the key question for 2011.

While Mr. Marks' view of risk is simple to explain and easy to comprehend, the reality is that investment risk is now global and complex, making investing a much more complicated and difficult task. The world today remains dominated by big macro related risks, four of which I highlight below. How these key risks play out in 2011 will define the returns to be earned for the risk taken during 2011.

1) Sovereign debt crisis contagion– The sovereign debt situation in Europe remains a major macro risk. Why does that matter to us in the US? Because the holders of

the debt are global and global financing relationships are intertwined. Banks, particularly European banks, are major holders of European sovereign debt. Each country is a major holder of other countries debt. If banks are forced to write-off losses on sovereign debt holdings, it impacts their capital position, which impacts their ability to lend to the private sector, which ultimately impacts global GDP growth. In 2010, both Greece and Ireland faced their day of reckoning. Both countries required bailouts and as a condition of obtaining financial assistance, each was required to implement severe budget austerity measures. As a result, both countries are likely to be economic basket cases for years to come. Even with a bailout, it is my opinion that the deal they signed to get bailed out just kicked the can down the road and both of these countries are highly likely to eventually default on their debt obligations in the future. While Greece and Ireland dominated the headlines in 2010, their economic size in the context of Europe and global GDP is fairly small. Even as small as they are, both required bailouts near $100B and caused significant volatility in global financial markets. There are more prominent European countries that could come under pressure in 2011 that would create a bigger problem for the global markets. Portugal, Italy, and Belgium are now showing distress. Italy owes France Euro 500 Billion. But the most important country short-term to keep an eye on is Spain. Spain as a percent of European GDP is a bigger player than Greece, Ireland, and Portugal combined. And Spain has an enormous debt problem in 2011. Spain has to refinance Euro 290 billion of debt in 2011, from a combination of federal, regional, and bank related debt. Big holders of Spanish debt are Germany, France, and the UK. Did I mention that Spain owns 1/3 of Portugal's debt? The question is who will lend the money to refinance the debt and will the interest rated required by investors be so costly that Spain (or Portugal or Italy) eventually goes the way of Greece and Ireland and requires a bailout too? Can the European Union come up with a viable debt plan to resolve this situation? Put me in the camp that says it is high unlikely. A positive resolution of this major risk would be a major positive for global stock markets, particularly in Europe. However, I believe this risk issue could become a major problem for the market at some point in the first half of the year.

2) China economic growth and inflation– Here is a scary stat for you to contemplate. Of the global GDP growth forecast for 2011, 25% of it is expected to come from China. How's that make you feel, knowing a Communist, centrally planned economy is the key economic engine of the world? From the depths of the 2008 credit crisis and global GDP collapse, China has gone on a bank lending spree over the past two years that has lead to a real estate and commodity boom. As a result, China is now experiencing major inflationary pressures. A Wall Street Journal article notes that at the peak of the US housing bubble, US housing prices peaked at 6.4X average annual earnings of the past decade. In Beijing, that figure today is 22X. Empirical Research shows the Beijing and Shanghai property markets relative to GDP as similar in profile to the Tokyo real estate market at the height of its real estate bubble in 1990. Japan then went on to experience a 20-year deflationary real estate bubble collapse. Chinese banks that lend are mostly

state owned enterprises that follow centrally issued mandates, with little to no regard for profit or losses. Easy credit availability eventually shows up in inflationary pressures. The Central Bank of China is now forced to reverse course and raise bank reserve requirements and interest rates to try to stave off further inflationary pressures. The city of Beijing will raise its minimum wage by 21% in 2011, after raising it 20% just this past June, a reflection of the inflationary pressures on the average Chinese consumer. Remember all those US jobs that moved to China? China no longer is the low cost labor leader and US companies increasingly look elsewhere to make investments. If you enjoy buying all those cheap items made in China at Walmart, you may eventually see prices head higher in the US since labor costs in China are escalating. As long as China GDP growth remains above 9%, its economy has an enormous ability to work through many problems. However, one thing we know is that when central banks tighten monetary policy aggressively in a short period of time, economies eventually slow. We also know, having learned the hard way in the West, that excessive lending in real estate will inevitably lead to loans losses by banks. Eventually, China will face its own banking crisis and have loan losses that the central government will have to help cover. This may not be a 2011 event, but some credit crisis is likely coming from China in the future. Any headlines of slowing China growth will cause concerns in stock markets around the world because the world GDP growth is so dependent on China growth. Major economies like the US and Europe are still in a precarious position and overly reliant on monetary and fiscal stimulus for growth. China economic growth should be on your radar screen when thinking about investment risk during 2011.

3) US budget mess, state and federal - Like Europe, the US is in its worst financial position in its history. However, unlike Europe, the US is going in the opposite direction in addressing its debt problems. In Europe, budget austerity is part of the approach to get debt under control. In the US, we are taking the complete opposite approach. We are two plus years into massive fiscal stimulus that was intended to stimulate economic growth. For all of the unprecedented amounts of stimulus already in the system, including zero interest rates since 2008, the best growth the US economy has mustered so far is one quarter of real GDP growth above 5%. Real GDP forecasts for 2011 are around 3.0%, revised up from a paltry 2.5% post the recent tax deal passed by Congress and signed by Obama in December. The US economic recovery is still so fragile that Obama/Congress had to extend the Bush tax rates another two years, extended unemployment benefits another 13 months, and add in a 2.0% payroll tax cut for good measure. For the prospects of better economic growth, we get another $850 billion of budget deficits. We are now $14 trillion in debt in the US. Here's another scary stat. When Ronald Reagan was in office, at the height of the early 1980's recession, we had $1 trillion of debt. 30 years later, our economy is 3-4X bigger but our national debt is 14X bigger. So, a debt level has been reached such that additional debt does not generate sufficient GDP growth to justify it. The day of reckoning is around the corner, and the US will eventually face its own era of budget austerity that will cause major anxiety across the populace. In 2011, this

will come home to roost in the form of state/municipal budget cuts, employment cuts, and tax increases. The 2008 Stimulus Plan enabled many states to kick the can down the road and use federal money to plug budget holes. With the Republican takeover of Congress, and with the advance of the Tea Party, states are highly unlikely to receive more money from the Federal government. Without stronger GDP growth, many states have budget holes in 2011 and 2012 that can only be filled from tax/fee increases or budget cuts that will weigh on economic growth and employment. US states constitute 13% of US GDP so this is not an insignificant issue. Some of the biggest states by economic contribution, CA, NY, and IL, are in the worst fiscal shape of all. States collectively are projected to have $1 trillion of unfunded pension obligations. Just one example. Pittsburgh PA has a city pension fund that has less than $500 million of assets and a pension obligation tab of $1 billion. If many of our towns/cities/states were stocks, you wouldn't want to invest a dime of your money in them. We could see increasing risk of debt default or bankruptcy from some cities in 2011. According to a NY Times article, there have only been 600 bankruptcy filings by cities/towns since 1937 and only 15 in the last two years. The article suggests there could be as many as 30 towns/cities in Michigan alone that would like to declare bankruptcy. Currently, by law, only cities and towns have the legal right to declare bankruptcy but there appears to be some push to change the bankruptcy law to allow states to file Ch. 9 bankruptcy. Municipal bond prices are reacting to this growing risk by falling rapidly at the end of 2010. Given our level of federal debt, US Treasury bond prices are also heading lower and yields heading higher. Keep an eye on these risks during 2011. If US Treasury yields go higher too fast, we could find ourselves in the same camp as Europe faster than we think possible.

4) Complacency - After periods of strong returns, it is human nature to get complacent. Things are going well, so you become less concerned about the future and less concerned about risk. Anecdotes of market complacency are popping up all over the place today. Wall Street strategists are by and large bullish on the US stock market for 2011, individual investor surveys of bullishness are not far from the peaks hit in 2007. The VIX, a gauge of market fear, is back to very low levels again. Sure, things are certainly not as dire as they felt in March 2009. But, I would argue that when you evaluate the true state of affairs of the US and global economy today, we are not yet at the point where one can throw caution to the wind. We are two plus years into a massive fiscal stimulus era and the economy is still in such a fragile state that it required another tax deal to be struck for another two years. The Fed has been forced to engage in unprecedented monetary policy (the so called Quantitative Easing, versions I and II) to try to encourage risk taking by investors (keep interest rates low to force investors to take on risk to earn higher returns). If these policies work, it means better returns for investors, which means more consumer spending, which means better economic growth, which eventually means more hiring. That's the goal. An improving job market is a key goal of the Fed policy and would definitely be a confidence booster for the stock market. While the employment picture is getting modestly better each month, we are still not at the point to know whether these

> unprecedented policies will have the intended effect or to fully understand their long-term consequences either. And we still have serious overhangs in the economy. The housing and foreclosure situation remains a mess. The true unemployment rate (U6) remains in the high teens and the average duration of unemployment is 34 weeks, almost double the 20 week profile of past recessions. Frankly, we are not exactly in a situation where anyone should be complacent. There is a ton of heavy lifting down the road.

After a major lull this past summer, the US economy appears to gaining strength again. This fits and starts recovery could be in the cards for some time. However, in investing, the trend is your friend. Despite the large macro risks I noted earlier, investors today are feeling better about the improving US economic data and the stock market ended the year on a strong note. Holiday consumer spending was better than expected, manufacturing activity remains robust, and monthly car sales are grinding higher. Monthly job growth is starting to turn for the better as well. If the monthly jobs figure can maintain a minimum of 150K of gains then I believe the market will maintain a bullish bias. In general, corporate America is in good shape. Cash levels are at record levels and as confidence on the outlook continues to improve, more of that cash will be put to work through M&A, share buybacks, and dividend increases. Capital spending should also increase, which is positive for hiring trends. As long as the key risks I highlighted earlier do not put a hole in the bottom of the boat, the stock market can offer another year of decent returns. But given the magnitude of the risks, the ride should continue to be quite volatile and one needs to be very adaptable to major changes as they occur.

Wall Street strategists today are forecasting 2011 S&P 500 earnings of $93/sh, up from appr. $85/sh for 2010 or 10% growth year over year. The average price target for the S&P 500 is 1367 or an expected gain of 9%. The S&P 500 Index level was 1258 at 12/31/10. Using Street consensus expectations of S&P operating profits of $93 for 2010, and apply a forward multiple of 15X to this figure would equal an S&P 500 target of 1395 or about 11% higher. So, from a fundamental basis, it is reasonable to expect a 10% stock market return for 2011. To the extent that US real GDP growth exceeds 3% during 2011, or job gains accelerate, earnings estimates will head higher and the market could do better. The market could see 10-15% downside risk if the economy, despite massive stimulus and easy money, only generates subpar growth (<3% GDP), corporate profit growth is not a robust as expected (<$93/sh), employment growth remains under duress, (unemployment >9%) housing prices decline, gasoline prices head higher, or unexpected events occur (?????).

In summary, it remains a difficult time to invest with confidence. Today, the underlying foundation for economic growth and investing is as shaky as it has been in the past century. Despite a long and difficult past three years, there remains major macro risks out in the world that are likely to require several more years to work through before a more normal investment environment returns. We are not in the buy and hold era anymore. Rather, we are in an era where risk management will dominate investment success for years to come. The issue of too much debt globally remains the overwhelming overhang on the global economy and world markets. The size of the debt out there clearly will weigh on economic growth and indicates we have many years to go before the issue recedes as a major risk. The day of reckoning in dealing with our debt in the US is quickly approaching. And like the past three years, we should see continued volatility as the policies and responses associated with dealing with these macro risks play out. The fundamentals of the economy appear to be turning for the better, but major global macro risks remain on the horizon and this is no time to get complacent. Stay on your toes is the goal for 2011.