MARKET OUTLOOK

JANUARY 2011

In the fourth quarter of 2010, the stock market was strong, ending with the best December since 1991. As has been the pattern of past recent rallies, smaller and riskier stocks outperformed the larger and higher quality companies. The gains in the quarter were a continuation of the rally which started in late August, not coincidently, the day that Federal Reserve Chairman Ben Bernanke announced the $600 billion expansion of quantitative easing (QE2). The purpose of this program is to create excess liquidity, drive up asset prices, lower interest rates, and thereby stimulate consumer spending which accounts for 70% of GDP. Stock and bond markets responded as planned, but late in the quarter bond prices reversed and declined causing yields to rise. Also helping stock prices were a number of positive economic news releases which effectively ended the fear, held by many, that the U.S. faced the possibility of a double dip recession. The good news included the late December agreement in Washington on a stimulus package that kept all tax rates at 2010 levels for two years eliminating the risk of a large tax increase in 2011.

As mentioned above, interest rates started to rise in the last six weeks of the quarter. The yield on the five year Treasury note rose 0.75%, while the yields on AA corporate bonds were up 0.73%. Despite this, yields on both are still below year ago levels. Muni bond yields rose 0.52% but are up 0.29% for the year.

Looking forward, economists have generally been modestly raising estimates for GDP and earnings. GDP growth is expected to be about 2.9% for 2010 and about 3.0% for 2011. This is significantly below prior recoveries from deep recessions and not strong enough to lower the unemployment rate significantly. Earnings for the S&P 500 are expected to increase 30% for 2010 and the consensus calls for a 13% gain for this year.

Stock and bond market volatility should continue to be high as there are significant headwinds and risk factors to be faced. 2011 should see the end of QE2 and a sharp reduction in federal fiscal stimulus and a reduction in spending by state and local governments with a corresponding increase in taxes. The housing market is still weak with a very large overhang of unsold homes. In addition, the Obama administration has indicated it will bypass Congress and impose strict regulations in many sectors of the economy which will add to the level of uncertainty on the part of businesses. Finally, the national debt is $14.0 trillion, up from $8.6 trillion in 2006, and is expected to reach $20 trillion in 2015. This is putting a severe strain on the nation's finances, especially if interest rates were to rise from today's historically low levels.

However, corporate profits and balance sheets are very strong and this cash could be used to increase hiring, make capital expenditures, buy back stock, or increase dividends. Inflation, excluding the commodity sector, is still low. Interest rates, while they have risen lately, are also still low enough to encourage capital spending.

With these cross currents, we will continue to pursue a cautious but opportunistic approach to the markets. We will stress high quality, balance, and diversification while looking for investment ideas in various sectors or investment themes.

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