

Market Review & Outlook

January 2011

Stocks in the U.S. registered their second straight year of gains, as the broad market averages enjoyed another year of double digit returns following the market recovery of 2009. Indeed, prices rose across the board in all major asset classes, but it was a volatile year, and the handsome gains really mask the turmoil that roiled the markets at times. From late January to mid-February of last year, the market experienced a correction of more than 9%, and then in the May-June timeframe, it declined a more drastic 17%. As fears of a “double-dip” recession subsided during the second half of the year, stocks rallied and gained momentum, bolstered by the Fed’s commitment to easy monetary policy through the announcement and implementation of a second round of quantitative easing (QE2). For a more detailed look at how the stock and bond markets performed last year, please refer to the following table:

Index	December 2010	4th Qtr. Performance	YTD Performance	Description (what the Index is comprised of)
S&P 500*	6.6%	10.2%	12.8%	Large Cap Stocks
DJ Industrial Average*	5.2%	7.3%	11.0%	Large Cap Stocks
NASDAQ Composite*	6.2%	12.0%	16.9%	Large & Mid Cap Tech Stocks
Russell 1000 Growth	5.5%	11.8%	16.7%	Large Cap Growth Stocks
Russell 1000 Value	7.9%	10.5%	15.5%	Large Cap Value Stocks
Russell 2000 Growth	7.6%	17.1%	29.1%	Small Cap Growth Stocks
Russell 2000 Value	8.3%	15.4%	24.5%	Small Cap Value Stocks
MSCI EAFE	8.1%	6.7%	8.2%	International Stocks
Lehman Aggregate Bond Index	-1.1%	-1.3%	6.5%	U.S. Government Bonds
Lehman High Yield	1.8%	3.2%	15.1%	High Yield Corporate Bonds
3-month Treasury Bill	0.0%	0.2%	0.2%	

Returns are estimates as of December 31, 2010. *Does not include dividends

For what it’s worth, strategists at prominent firms such as Goldman Sachs, Morgan Stanley, and BlackRock are optimistic about the coming year and most are predicting another year of double-digit gains. However, it’s important to remember that none of the big Wall Street firms predicted the financial crisis and although we have not gone back and checked all the predictions, we would bet that most prognosticators looked silly with their 2008 stock forecasts. Not everybody is so upbeat about the coming year and there is still a wide divergence of opinion about the markets and economy among those who are not paid to be professional optimists.

With the widespread belief that the Fed is going to provide a “backstop” against losses, we could see the market continue its recent momentum. With that being said, this bull market is not quite 2 years old yet, and the easy money has likely been made. Other factors

suggest that short term caution may be warranted: The volatility index (VIX) is down to the “complacency levels” seen last April right before the 17% correction and Investors Intelligence data show advisory sentiment approaching the bullish extremes of October 2007 when many benchmarks made historical highs. Also, stock leadership is narrowing, internal momentum is waning, and nearly every major sector is overbought on a technical basis. Moreover, the correlations between various asset classes are decreasing, implying that investors are becoming more selective.

From a longer term perspective, the recent rally in stocks (and indeed, much of the rally since the market lows of 2009) has been speculative in the sense that shares characterized by low stability of earning and high sensitivity to market risk outperformed those ranked higher in quality, yield, and stability. If one looks at the entire S&P 500 as relatively “high quality,” you can observe higher levels of speculation in small cap indices such as the Russell 2000 and higher beta indices like the NASDAQ.

The relative valuation ratio of the S&P 500 compared to these other indices has fallen to multi-year lows. Historically, such episodes have typically been followed by several years of poor relative performance in speculative stocks, and the corresponding outperformance of higher quality issues.

In the bond market, yields rose precipitously over the last 2 months of the year, with the yield on the 10-year Treasury bond rising from 2.38% to as high as 3.52% by the end of the year (it currently resides at 3.42%). This somewhat dampened the gains that bond investors had enjoyed during the year, and signaled to some as proof positive that the long bull market in bonds is over, something that PIMCO bond guru Bill Gross had proclaimed not too long before yields began to rise. If economic growth continues to strengthen as most pundits expect, then yields could continue going up, which would generally be a bad thing from the

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perspective of those owning bond mutual funds, as the prices of bonds move inversely to yields. Longer maturity treasury bonds would be the most vulnerable to such pressures, so if you are a conservative investor disposed to owning government bonds, your best bet is the safety of short term treasuries.

Over the course of 2010, the economic recovery transitioned from temporary support from government stimulus and inventory rebuilding to more sustainable gains in underlying demand – household spending and business fixed investment. The pace of economic growth was sufficient to keep the unemployment rate steady, but we will need to see much stronger growth to push the unemployment rate down more significantly. Overall, economic growth should improve this year, but it's unclear how much, and significant headwinds still remain. Lingering problems in the housing sector, tighter state and local government budgets, and the decrease in the federal fiscal stimulus will restrain overall economic growth. In addition, higher gasoline prices may dampen the pace of consumer spending growth. Of course, stronger job growth would help counter these pressures and provide fundamental support for the housing market and help to lift state and local tax receipts.

The bearish contingent of pundits who continue to question the credentials of this recovery believe the significant problems that caused the financial crisis of 2008-2009 were largely papered over rather than resolved. In their minds, it's a tripling of the Fed's balance sheet, a suspension of fair-market disclosure by major financial companies, and an ongoing federal budget deficit of 10% of GDP that has the economy slowly recovering and so far, investors apparently care little about the dangers of the policies that have produced this outcome. These pundits are the same

folks who believe that we are experiencing a cyclical bull market in the midst of a longer term, secular bear market that began in the year 2000.

Unfortunately, we won't know until much later which camp gets these things right, but we are guardedly optimistic about the prospects for 2011 (but might feel better if there were a stock market correction in the near term to remove some of the froth). As many continue to point out, there is an unprecedented amount of monetary and fiscal stimulus sloshing around the global economy, so all the supports are in place. Sure, there are many central banks around the world that have raised rates in the past year, but generally speaking they are still at historically low levels. Could there be unforeseen shocks that cause a rapid sell off and return to risk aversion? Sure there could, and they are numerous – sovereign default amongst the weaker European union countries, heightened military conflict on the Korean peninsula, widespread municipality debt defaults, and further declines in the housing market – are but a few of the possibilities.

However, complete risk aversion is certainly not a successful long term investment strategy, so the key is to have a diversified portfolio, especially when the future seems so uncertain. Generally speaking, stocks are more attractively valued than bonds right now, but if you are a bond investor, it's probably better to shorten your maturities and avoid treasuries.

If you have a general question about your account, please contact our customer service at 800-535-4253 extension 152. If you need investment advice, please contact me or your firm's designated consultant. You can reach me at extension 178 (510-740-4178) or at john.w@wespac.net. John Williams, Manager of Advisory Services – WESPAC