The Markets – Fourth Quarter 2010: *Another solid year buoyed by QE2, improving economic picture, strong balance sheets and positive earnings.*

Stocks spent much of November consolidating and digesting the strong September rally before resuming their march higher in December posting gains around the world (for the most part). The S&P 500 was up 6.68% in December and 10.76% for the quarter bringing the 2010 total return to 15.06%. Large-cap stocks, however, trailed small- and medium-sized company returns, each of which returned nearly 27% for 2010.

In terms of U.S. sectors, all 10 major sectors posted increases for the year. Consumer Discretionary, Industrials, and Materials were the strongest performers, while the more conservative Health Care, Utility, and Technology sectors were the weakest as investor risk appetite continued to increase.

Growth continued to outperform value in terms of style, although the differential has started to narrow as correlations have begun to break down and volume has picked up in individual stocks relative to exchange traded funds (ETFs).

Emerging markets (+17.18%) continued to out-perform developed markets due to significant sovereign debt issues in the so called PIIGS (Portugal, Ireland, Italy, Greece and Spain).

Commodities had a stellar year as nearly all commodities moved higher with Palladium (+95.6%), Cotton (+92.3%) and Silver (+83.5%) leading the way. The most notable exceptions to the commodity trade were Cocoa (-7.6%) and Nat Gas (-20%).

While the stock and commodity markets had a great fourth quarter, the bond market experienced negative returns as interest rates rose sharply during the quarter. The interest rate on the benchmark 10-year Treasury bond rose from 2.52% to 3.30%. Ten year yields are still lower than the 3.84% as of YE2009, but significantly higher than the 2008 trough in yields of just over 2%.

The BarCap Aggregate Bond Index, which measures the performance of the taxable bond market, lost 1.3% during the quarter, but still managed 6.54% for the year as bond investors flocked to corporate bonds in search of yield. The BarCap Municipal Bond Index declined 4.2% as investors worried about the deteriorating financial condition of a number of municipalities.

Outlook: We remain relatively optimistic about the equity markets. It appears that some analysts profit forecasts may be a little high, but given improving GDP growth, it is reasonable to expect mid-to-upper single digit growth for the market as a whole in 2011. U.S. stocks could surprise to the upside if performance anxiety sets in and retail investors begin to move out of cash and bonds and in to stocks and stock funds. Given the amount of building optimism, the market is also vulnerable to an unforeseen shock such as a "flash crash" type event, or a sovereign debt default. The U.S. stock market may be due for a correction or consolidation, but barring any extreme shock, we feel a pull back would likely be relatively short-lived and could potentially set the stage for another impressive rally considering all the cash on the sidelines which could find its way into the market.

Consumer spending has strengthened more than expected (up 5% over 2009 with luxury/jewelry spending up 8.4%). The consumer has, to some degree, been crowded out by government spending now that Washington spends approximately $1.3 trillion more annually than it takes in. However, at nearly 68% of GDP, continued growth in consumer spending would be a welcomed tailwind to the somewhat muted economic recovery.

Housing prices have plunged 30% from the 2006 peak and are likely to remain under pressure given the "shadow" inventory, stubbornly high unemployment rate and recent up-tick in mortgage rates.

Yields likely will rise, although not dramatically given the slack in unemployment, excess capacity in the U.S. economy and an active Central Bank. It is very plausible that the 10-year U.S. Treasury yield could rise by a point or so over the next 12 months. There is a relatively strong relationship between the 10-year yield and nominal GDP growth, which is tracking at roughly 4.5% year-over-year. A rise in yield to 4.5% would equate to approximately a 5% decline in the price of the 10-year Treasury.

Positives:

- Insider sentiment at an all time high
- Economic Diffusion Index (positive – negative reports) picking up steam
- Favorable Election cycle and tax clarity
- Inflation expectations contained
- Credit improving and cash on balance sheets
- Retail investors – bullish sentiment is high (AAII), but individuals are not putting money where mouth is as cumulative 3yr bond/EM flows are significantly above mean, while equity significantly below.

Risks:

- Housing
- Unemployment
- Sovereign debt
- China tightening
- Municipal struggles
- Aggressive profit margin forecasts on average

Models:

1. Equity/Commodity:
    a. Overweight value and slightly overweight mid- to large-caps: We continue to favor companies with strong balance sheets and cash flow trading at reasonable valuations.
    b. Dividends will be more important and have weighted the models towards companies which pay well-covered and growing dividends.
    c. Maintain weighting to non-US stocks and within International we continue to favor developing and resource rich economies such as Brazil, China and India.
    d. Maintain a weighting to commodities for both an inflation hedge and due to uncertainty about the global economic recovery.
2. Fixed Income:
    a. Continued tilt towards intermediate term duration to protect against interest rate risk.
    b. Overweight Investment Grade with a small tactical allocation to high yield and MBS given declining default rates and likely support due to Government Large Scale Asset Purchases.
    c. Should BAB be killed once and for all, small allocation makes sense given spreads and supply and demand dynamics.
    d. Continued indiscriminate selling of municipal debt is beginning to create opportunity.
    e. Continued allocation to International Treasuries as a hedge to current US monetary policy.
    f. Maintain weighting to TIPs as a relatively low-volatility inflation hedge.

Performance

Model Portfolio	Fourth Quarter	One Year	Three Year
Aggressive	8.32%	11.75%	-1.00%
Moderate Aggressive	7.46%	11.73%	-0.27%
Moderate	4.59%	9.52%	0.23%
Income & Growth	2.02%	8.82%	2.64%
Conservative	1.02%	8.07%	3.38%
S&P 500	10.76%	15.06%	-2.86%
Russell 2000	16.25%	26.85%	2.22%
MSCI EAFE	6.61%	7.75%	-7.02%
MSCI Emerging Markets	7.34%	18.88%	-0.32%
S&P GSCI Commodity	13.41%	9.03%	-12.84%
BarCap US Agg Bond	-1.30%	6.54%	5.90%