



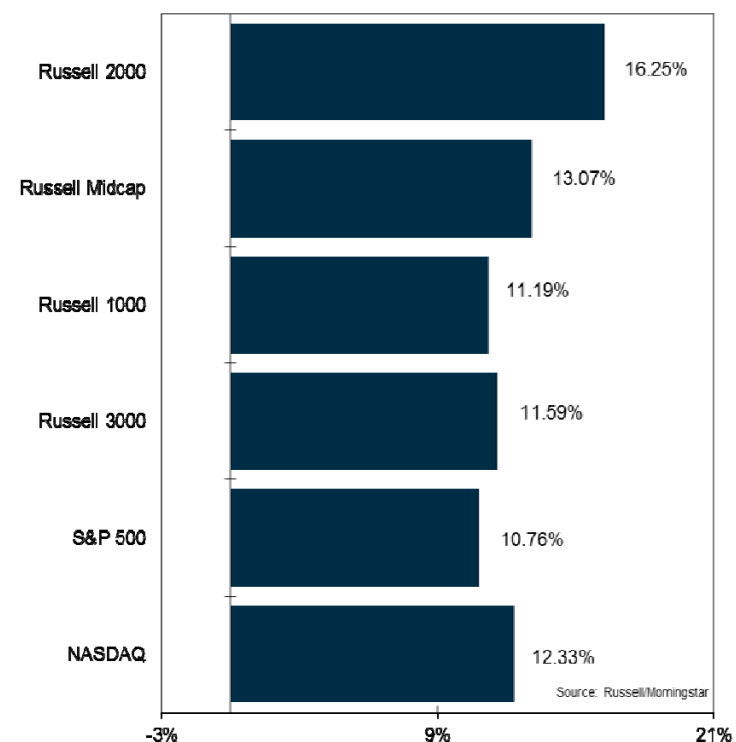
## Fourth Quarter Market Summary

### The Economy

The economy showed definite signs of improvement in the fourth quarter of 2010, and if the trends continue, is poised to show strong growth in 2011. Late in the quarter, third quarter GDP growth was revised higher, and consumer spending seems to have rebounded quite nicely, as retailers report robust Christmas sales. Retail sales are now only slightly below their prerecession highs, due to strong demand for consumer goods on the back of low rates for consumer loans. However, it is likely that the rate of increase in consumer spending will be unsustainable in the current environment of deleveraging, because spending has been exceeding income.

Perhaps the pivotal moment in the fourth came when the Federal Reserve officially announced its second round of quantitative easing, or “QE2”. The announcement had been widely anticipated, and had been one of the drivers of the equity market’s strong performance in September. Through QE2, the Fed plans to purchase up to \$600 billion of Treasury securities at a rate of approximately \$75 billion per month. If carried out to completion, the Fed’s balance sheet will have ballooned to about \$3 trillion from about \$800 billion prior to the financial crisis.

**Broad Market Index Returns**  
Fourth Quarter 2010

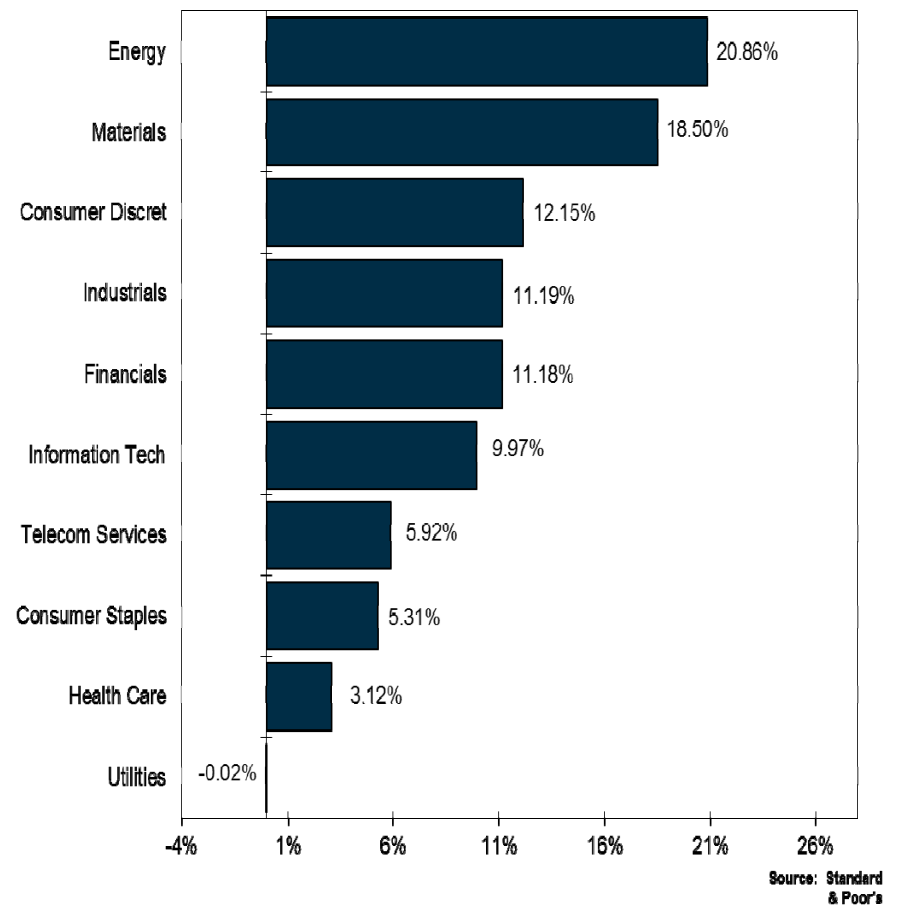


The Fed has come under widespread criticism for embarking on such an ambitious plan, particularly as it appears the economy is no longer in danger of a “double dip” recession. For its part, the Fed believes that QE2 is necessary to fulfill the dual mandates it has been given: promoting price stability and full employment. With inflation below the Fed’s 1.5%-2% target, the unemployment rate still hovering close to 10% and lack of clarity on the fiscal policy front, the Fed believes it necessary to implement QE2 in order to keep the economy’s trajectory pointing upward.

The mid-term elections should also prove to be of help to the economy in 2011. Based on the results, in which Republicans and Tea Party candidates gained a significant number of congressional seats, it is apparent that the country is seeking controls on, and cuts to, spending. Finding ways to cut spending has become even more important now that President Obama has signed the bill extending the Bush tax cuts. As greater fiscal controls are established, the economy’s health should improve as the debt burden as a percentage of GDP shrinks.

Europe continues to experience sovereign debt issues, with Ireland being the latest country to need assistance from the European Union. The European Central Bank (ECB) has been purchasing bonds of troubled banks in the wake of the various sovereign problems. Late in the fourth quarter the ECB stepped up its program, which had initially been put in place in May as the sovereign issues began to unfold, in an effort to head off further problems in Ireland and other countries such as Portugal.

**U.S. Equity Market Returns by Major Sector**  
(Securities in S&P 500, 4th Quarter 2010)



## **Highlights**

### **GDP**

The Bureau of Economic Analysis released the third estimate of third quarter 2010 GDP, an upward-revised 2.6%, up from the initial estimate of 2.0%, and a strong improvement over the second quarter's growth of 1.7%. In addition, real GDP rose 3.2% during the year ending September 30<sup>th</sup>, the largest one-year increase since the beginning of 2005. Economists are now forecasting more solid growth for 2012, with some looking for growth of 4%. Driving this growth will be continued improvement in corporate profitability, which will yield businesses the resources needed to hire and invest. It is also likely that household spending will continue to grow, but within limits. As mentioned above, recent consumer spending data are improving, and the tax deal's inclusion of a payroll tax cut and extension of unemployment insurance benefits are estimated to add \$150 billion to households' balance sheets in 2011. Serving as potential drags on growth will be continued high levels of foreclosures and the European financial situation.

### **HOUSING**

The housing market exhibited mixed signals in the third quarter. Existing home sales rebounded from poor results in the second quarter, with sales rebounding 5.6% in November after a minimal decline in October. The increase in sales, coupled with a moratorium on foreclosures, has served to reduce the number of months of supply to approximately 9.5 from about 12.5 in July. The reduction in supply should serve to support prices somewhat going forward, particularly as buyers seek to take advantage of still-low mortgage rates and relatively low home prices. While some servicers have ended their moratoriums on foreclosures, there will be an additional supply of foreclosures processed, which could serve to drag out the recovery.

### **EMPLOYMENT**

The employment situation showed slight improvement in the fourth quarter, but is likely to witness somewhat of a pickup in 2011 as the economy begins to accelerate. After adding 172,000 jobs in October, November's gains of 39,000 were meager, and far below what economists had expected. In addition, the unemployment rate rose to 9.8% in November, even though economists had expected it to hold steady at 9.6%. The reasons for the poor results in November can be attributed to disappointing gains in the private sector, which added only 50,000 jobs, the lowest amount since January. The poor results affected both the manufacturing as well as the service sectors. The unemployment rate rose because more people were laid off, not because more began to look for employment.

Many economists believe that current levels of hiring will not be able to make meaningful reductions in the unemployment rate, and it may not be until late in 2011 or into 2012 before declines in the rate come to fruition.

## **FED POLICY**

In December, the Federal Open Market Committee (FOMC) announced that it will continue with its quantitative easing program. As mentioned above, the FOMC announced that it will expand its balance sheet and purchase \$600 billion in Treasuries by mid-2011. The program is the FOMC's attempt to fulfill its dual mandate of promoting price stability and full employment. In a quantitative easing program, the central bank purchases securities in an effort to reduce long-term interest rates and increase inflation expectations. The purchase of the securities adds liquidity to the financial system.

The committee also reiterated it will maintain a fed funds target in the 0% to 0.25% range "for an extended period." Many analysts believe that the tax bill negotiated between President Obama and congressional Republicans, as well as a renewed focus on spending cuts, will be the fiscal "release valve" that will take pressure off of the Fed. With the anticipated pickup in economic growth, it is unlikely that additional aggressive monetary policy steps will be necessary. The Fed will most likely step back and assess the impact of the quantitative easing program and legislative package on the economy. Since the tax deal was more aggressive than many had expected, GDP growth should receive a large enough shot in the arm that would mitigate the need for the Fed to take further action.

Economists do not expect, however, that the economy's growth will be so strong that the Fed will need to raise rates anytime soon. They cite very low inflation and continued deleveraging as factors enabling the Fed to maintain the current regime throughout 2011 and perhaps into 2012. It is also likely the Fed will first reduce the size of its balance sheet before implementing a rate increase.

## **Interest Rates**

Unlike the third quarter, which saw interest rates decline, the fourth quarter was generally a difficult one for the fixed income market, with several factors weighing on bond prices. Early in the quarter the European sovereign debt situation made Treasury investors nervous due to worries whether the contagion may spread. Then, in a "buy on rumor, sell on fact" scenario, the bond market sold off once the Fed formally announced its QE2 program in November, as anxieties over excessive amounts of money in the system began to



## Equities

During the fourth quarter, stocks followed through on a strong September rally. Historically, when stocks have gained more than 5% in September, the fourth quarter is also strong, and this year was no exception. The Russell 1000 Index of large capitalization stocks advanced +11.19% during the quarter, and is up +16.10% for the entire year. Small capitalization stocks also advanced, gaining +16.25% for the quarter, and +26.85% for the year. Growth stocks outperformed value during the quarter overall, however, value outperformed growth in the month of December. Because they are more sensitive to the business cycle, value stocks tend to be strong relative performers at the onset of an acceleration in economic growth.

International stocks, while posting gains for the quarter, far underperformed domestic equities, perhaps because of renewed fears of sovereign debt problems. The MSCI EAFE Index of developed markets stocks advanced +6.65% for the quarter, performing particularly well in December (+8.11%). For the year, the index was up +8.21%. In what has become a common occurrence in recent quarters, emerging markets stocks outperformed their developed markets counterparts during the quarter. The MSCI Emerging Markets Index generated a return of +7.36% during the quarter, and was up +19.20% for the year. Emerging markets have been the performance leaders for some time, and there is some concern among investors that China's policymakers will be tapping the brakes on its supercharged economy.

Looking ahead, many analysts believe stocks are poised to continue to perform well in 2011 for several reasons: 1) the expected acceleration in economic growth; 2) the relative attractiveness of equities to bonds; and, 3) the fact that 2011 is the third year of a presidential term, which historically has proven to be a very good year for stocks.

**Non-U.S. Equity Market Returns**  
4th Quarter 2010

