



## Take the Money and Run

### In Review

*“...we have run the risk of being viewed as an accomplice to Congress’ fiscal nonfeasance...There are limits to what we can do on the monetary front to provide the bridge financing to fiscal sanity.”* **Richard Fisher, President of Federal Reserve of Dallas**

The performance for the indices we track is stated below for the quarter and for the calendar year:

Benchmark Performance					
Data as of December 31, 2010					
	<u>4Q10</u>	<u>2010</u>	<u>3 Year</u>	<u>5 Year</u>	<u>7 Year</u>
Bardays 5 Year Muni	-1.57%	3.40%	5.52%	5.00%	4.08%
Bardays Aggregate	-1.30%	6.54%	5.91%	5.80%	5.10%
S&P 500	10.76%	15.06%	-2.86%	2.29%	3.85%
Russell 1000	11.19%	16.10%	-2.37%	2.59%	4.33%
Russell 2000	16.25%	26.85%	2.22%	4.47%	6.36%
iShares MSCI EAFE	6.49%	7.62%	-7.01%	2.36%	6.22%
iShares MSCI Emerging Markets	7.24%	15.95%	-0.15%	11.85%	16.65%

Source: PSN Informa

Below is a chart of the S&P 500 Index segmented by quarterly results. As you can see, from the market bottom in late August, stocks made a strong run to the end of the year:

**S&P 500 Index 1 Year Chart**



Source: Strategas

The two seminal events for the market in 2010 were the beginning of the Euro area debt crisis in the April/May time period and the decision by the Fed to embark on a second round of quantitative easing (dubbed QE2). QE2 was first signaled by the Fed at the end of August, and announced and implemented in November. Remember that QE1 ended in March with the final purchases of Mortgage Backed

Securities (MBS). The Fed began to suggest an end to their monetary accommodation at that time, stating their intention to let their mortgage holdings run down (through prepayments) thereby shrinking the size of their balance sheet. Shortly thereafter, the Greece crisis hit, the stock market fell and bond yields worked their way down to historic lows.

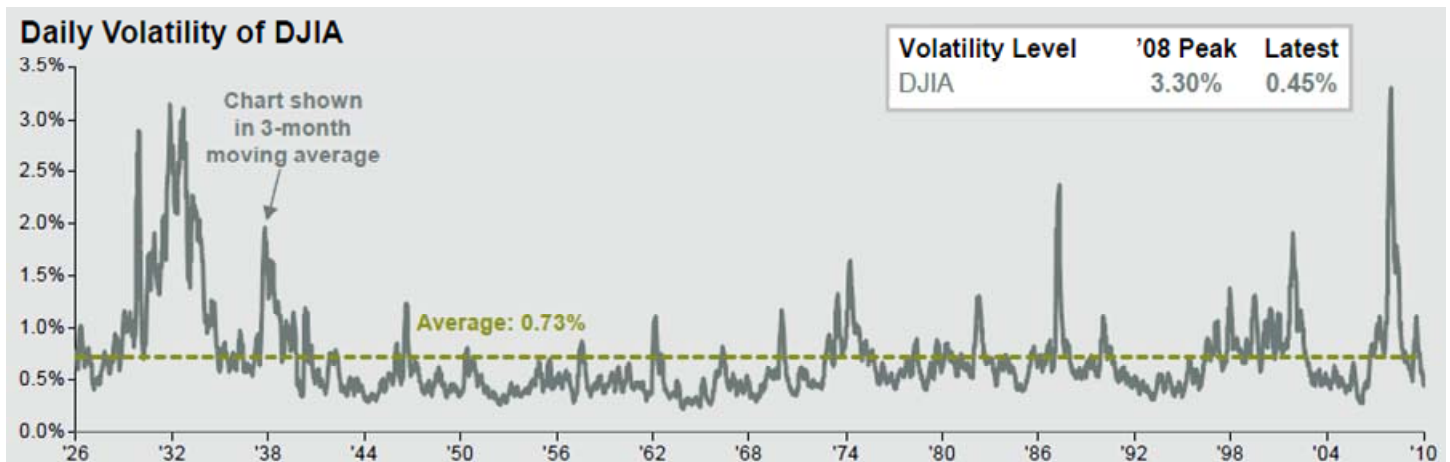
The Volatility in the market throughout the year reflected those events. The VIX spiked in April when the crisis surfaced and dropped coincident with the run in stocks when the Fed announced their new intentions:

### CBOE Volatility Index – VIX 1 Year Chart



Source: Bloomberg

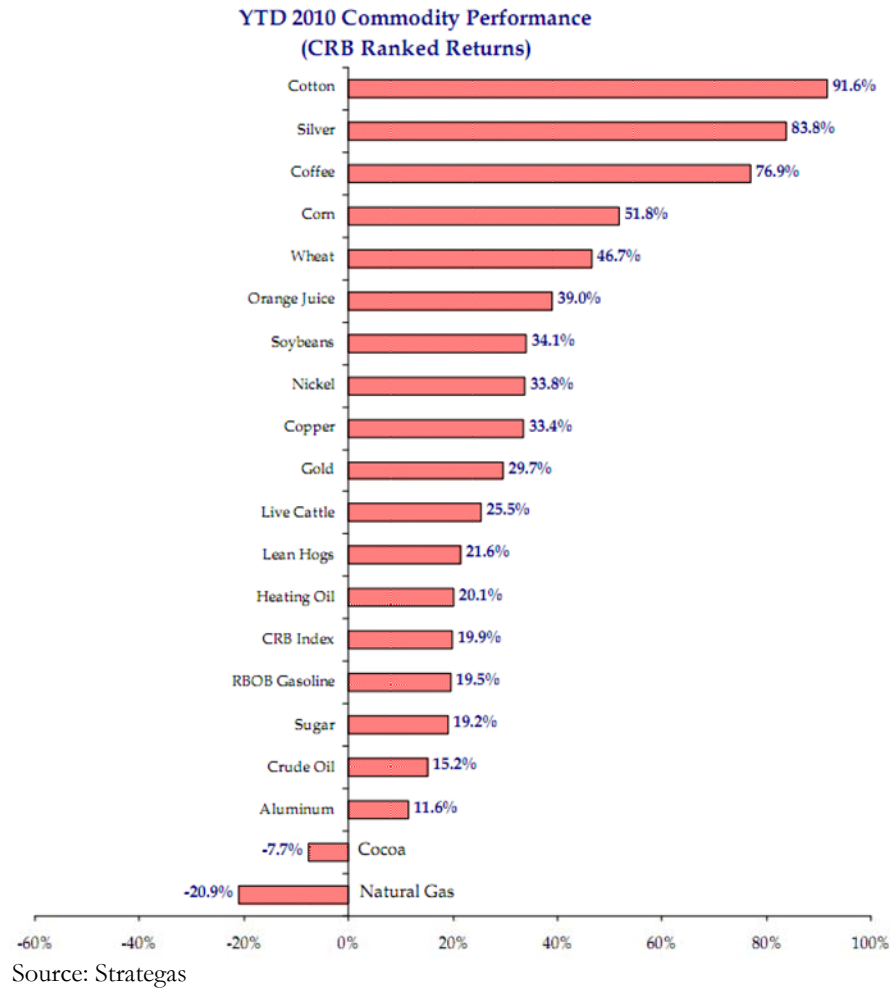
Overall market volatility (this time measured in the Dow Industrial Index) has, subsequent to the Fed announcement in August, returned to extremely low levels despite the lack of resolution of many of the uncertainties left over from the financial crisis. The following chart provides historical context, with the current reading below the long term average:



Source: JP Morgan

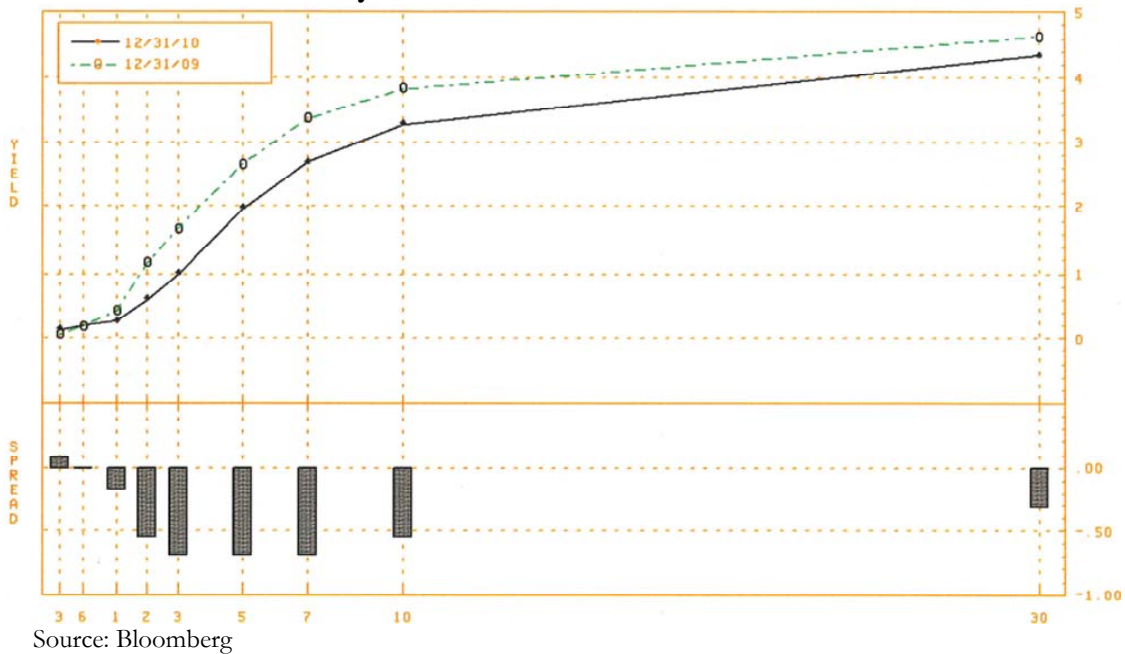
As for other asset classes, Gold had a good year demonstrating relatively steady appreciation as investors sought out investments that would shield them from a falling dollar. It ended the year up almost 30%, but other members of the commodity complex fared even better. Commodities' results were driven by a

general loss of confidence in paper money, by demand from the strong growth in emerging economies, and the recovery in the developed world:



In the treasury markets, yields for the year were lower across the board despite the increase in the Federal deficit and the need to issue more securities. The Fed's decision to purchase treasuries helped to keep yields down, as investors bought ahead of the November implementation of QE2. The chart below compares the yield curve at the beginning (green dotted line) and end of the year. Rates closed down more than 50bps across several maturities, and many parts of the curve spent a considerable part of the year at lower levels, only rising in the last quarter from those historic lows:

### Treasury Yield Curve 12/31/09 vs. 12/31/10



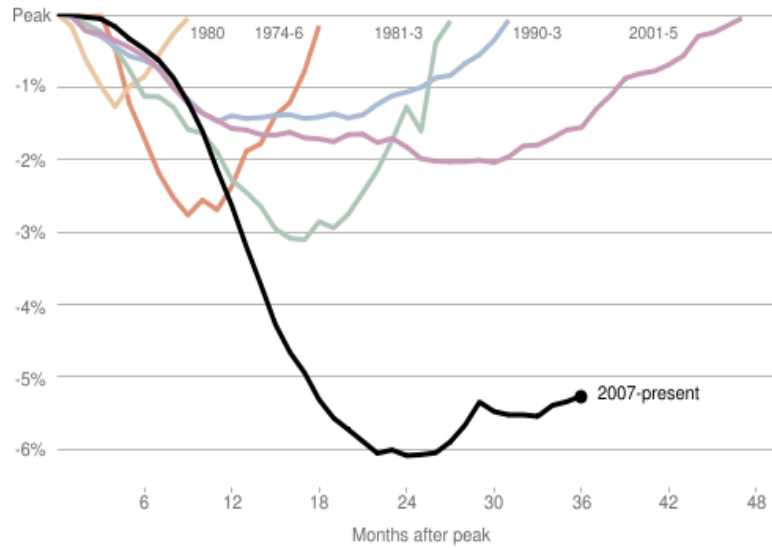
The 30 Year Breakeven (equal to the yield on the 30 year treasury less the 30 TIP), which is a reflection of market inflation expectations over the next 30 years, dropped subsequent to the Euro debt crisis and continued doing so into the summer as renewed deflation fears surfaced. The Fed’s QE2 announcement in Jackson Hole in August reversed that trend and the level has returned to pre-crisis types of readings of roughly 2.5%, near the Fed’s long term inflation target:

### 30 Year Breakeven – 1 Year Chart



The International Monetary Fund reported that economies grew respectably in the year led by developing markets with an average 7.1% GDP growth (versus their 5% 20 year average) and developed markets with 2.7% – resulting in global GDP growth of 4.8% for 2010. In the US, employment remains the primary uncertainty (along with housing) as the job market is experiencing its slowest recovery in the post WWII period:

### Comparing Recoveries: Job Changes



Source: thebigpicture.com

While some of the data around employment appears to be getting better, the housing market has shown signs of renewed weakness recently. While the chart below shows that house prices as measured by the Case Shiller Index have recently ticked down, a more nuanced reading of the data suggests a deceleration of the rate of decline and the possible stability in prices. Most weakness of any magnitude remains relatively focused geographically (the largest three year declines are in Las Vegas -50.2%, Phoenix -46.1% and Miami -39.6%). This data is being watched closely as further declines will put many more homeowners in a negative equity position, potentially leading to further consequences for the banking system:

### Case Shiller Home Price Appreciation Index



Source: Miller Tabak

There are some indications of improvement in the labor market as seen in the internals of the headline data. Below, the hiring intentions of small businesses as measured by the NFIB (National Federation of Independent Business) are finally turning up, an important statistic given the importance of small business to labor market growth:

## NFIB Small Business Hiring Index



Source: Bloomberg

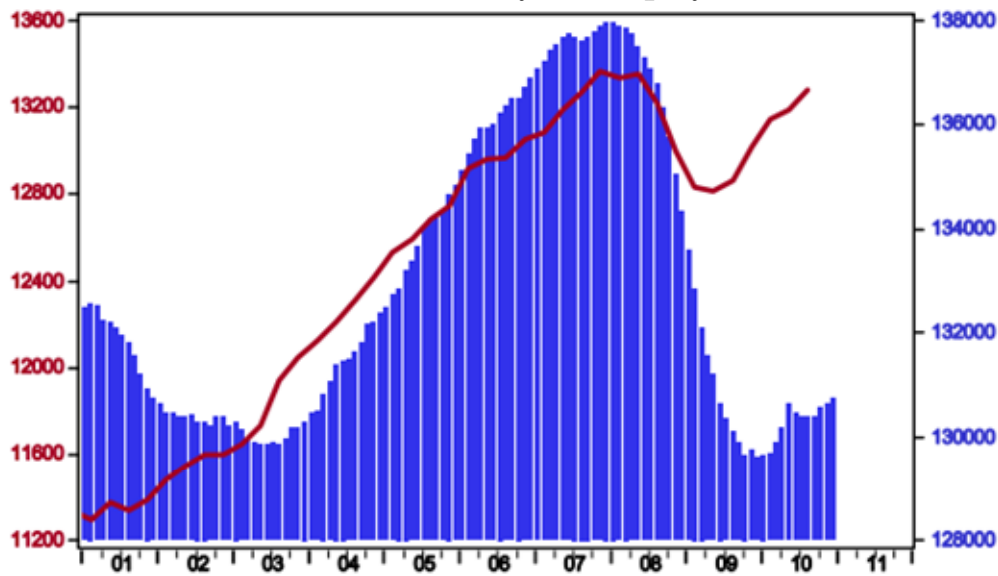
A sustained increase in employment would help to stabilize housing and boost consumer confidence as well.

### Outlook

*“...we are in danger of assigning to monetary policy a larger role than it can perform, in danger of asking it to accomplish tasks that it cannot achieve, and, as a result, in danger of preventing it from making the contribution that it is capable of making.”* **Milton Friedman**

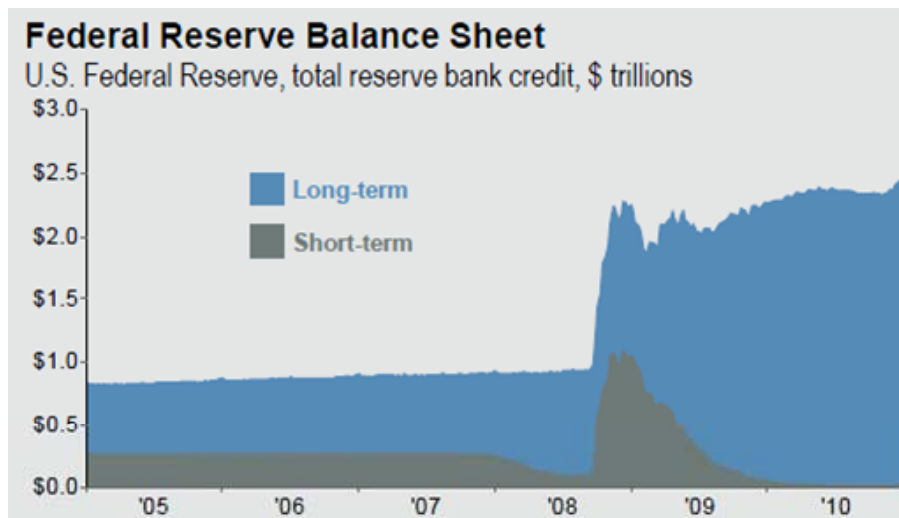
The chart below is perhaps the best summary of what is different about this cycle and how that affects the outlook for the markets and the economy. The red line represents the gross domestic product for the US which has climbed back to the level reached at the pre-crisis peak. The problem, however, is that we have been able to do so at a much lower level of employment as shown in the blue bars (roughly 7MM fewer). As such, many economists predict that the structural level of unemployment has been raised for at least the intermediate time horizon:

## GDP versus Total Payroll Employment



Source: Strategas

To fill the gap in demand caused by the higher level of joblessness, the government, through monetary and fiscal measures, has endeavored to raise the aggregate level of demand until the recovery takes hold and the economy can begin to create jobs. The Fed has been increasing the size of its balance sheet through asset purchases and is scheduled to add \$600 billion (QE2) more through June of this year. At the end of the current purchase program, the Fed's balance sheet will be roughly \$3 trillion up from pre-crisis levels of around \$800 billion:



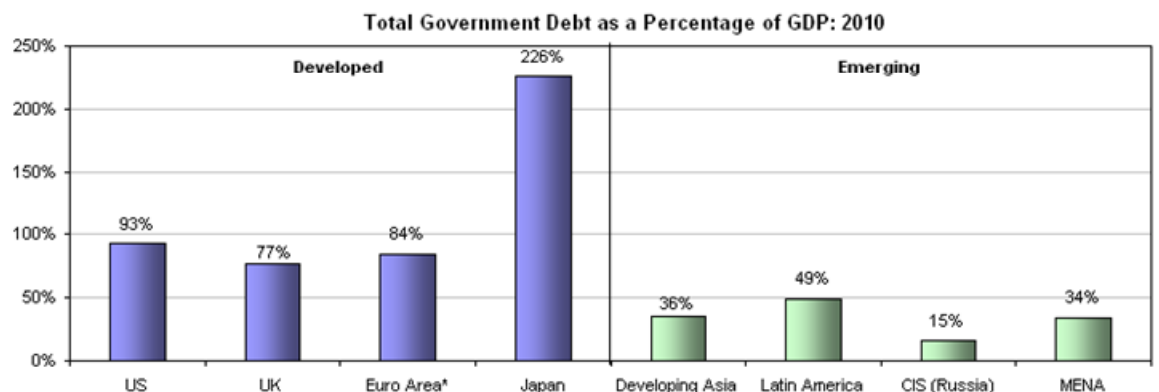
Source JP Morgan

The Fed's decision to embark on the second round of QE has been especially controversial. Many have argued that the Fed's overly lax monetary policies in the last decade set the stage for the housing bubble and are concerned about the unintended consequences of further intervention. The Fed's disproportionate purchases of treasuries distort the price discovery mechanism and ultimately lead to the misallocation of capital which should have ramifications at some point – potentially manifesting itself in another difficult market period.

Furthermore, almost no investors at the corporate or the sovereign level have been forced to take haircuts and/or participate in the restructuring of the indebted entity. As a result, debt continues to be mispriced

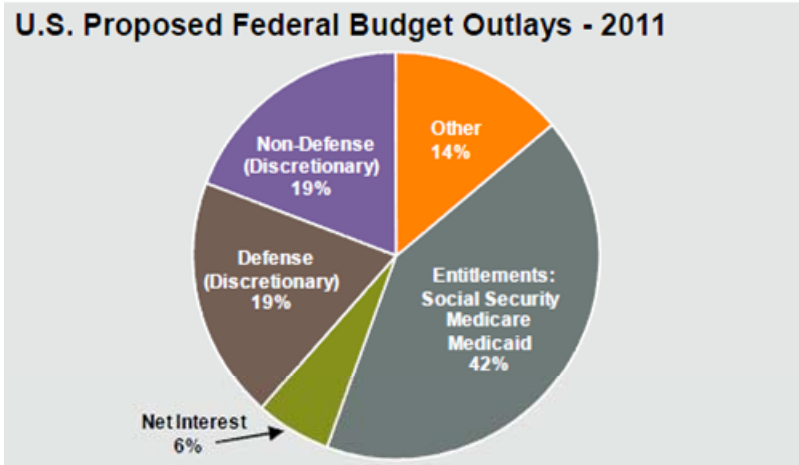
and over-indebted entities and countries are trying to solve their problem by issuing more debt. Apparently, the fear among policy makers in a post-Lehman world is that forcing investors to share the pain will disrupt the markets in a similar fashion. While possibly true as an immediate reaction, it should also raise the cost of capital to the more indebted, less creditworthy entities and therefore bring the subsidy of falsely lower rates to an end. This is necessary if we are to prevent a repeat of the process that got us into trouble in the first place.

Additionally, the resources of the government have become stretched and the growing deficits have become increasingly conspicuous in the face of what has transpired in Europe. The passage of the health care bill plus the extension of the Bush tax cuts have added to what was already supposed to be a substantial shortfall for 2011. The result is that our debt to GDP ratio is at levels that have empirically been proven to slow economic growth (by up to a full percentage point per Reinhart and Rogoff). Unfortunately there is no end in sight as difficult decisions have yet to be made. The chart below contrasts the developed worlds' debt levels versus that of the developing world:



Source: International Monetary Fund, World Economic Outlook Database, October, 2010. \*Euro Area: Germany, France, Italy, Spain

But while government policy is inflationary, economic conditions appear more deflationary with a lot of slack in the labor force and still a significant amount of debt that needs to be worked off. The result is that the Fed's actions, along with the increased government spending, are more likely to move asset prices than consumer prices over the near term which is what we have witnessed. The risk is that a more widespread form of inflation will develop if fiscal policy is not brought under control. Unfortunately, we have very short election cycles; yet, we have problems that require a longer term mindset – not a recipe for a political solution.



Source: JP Morgan

As seen above over two thirds of government spending is on entitlements, defense and interest on the debt – areas that have proven extremely difficult to cut in the past. The good news is that these problems are fixable if addressed quickly. President Kennedy said, “A journey of a thousand miles must begin with a single step”- perhaps some recent moves out of Washington are those first steps.

The perception of Europe, on the other hand, is that they have set out on a path of controlling government spending, have at least paid lip service to addressing entitlements, and their central bank has signaled that they want to raise interest rates before the Fed. The result has been that investors have begun to discount a lower probability of a tail risk event and sovereign credit spreads have come down recently as seen below:

**Sovereign CDS Spreads for Greece, Portugal, Ireland and Spain**



Source: Miller Tabak

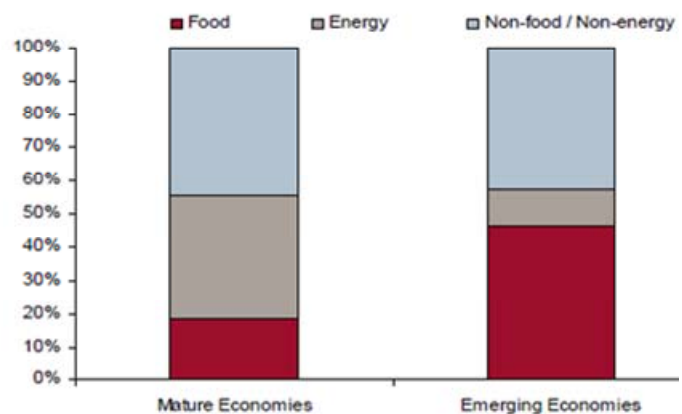
We continue to be concerned with the situation in Europe as there remains too much debt in some countries. The proffered solutions merely defer the difficult decisions as eventually some restructuring will have to transpire.

In emerging markets, while government balance sheets are in good shape, they are confronted with sharply rising food costs which have a disproportionate effect on their inflation rates. As seen below on the right, food inflation in red has roughly five times the effect on emerging economies as it does in the developed world as more income per capita is spent on food (up to 50% in many countries):

**CPI Inflation Contribution to the Total**



Source: ISI Group, Credit Suisse



The result has been that emerging market governments have been raising interest rates and letting their currencies appreciate to mitigate the inflationary pressure. As seen below, the Chinese have let the Yuan rise as their inflation rate picked up:



Source: Wall Street Journal

The higher level of interest rates, while helping their currencies, may create more volatility in their equity markets as monetary conditions tighten.

### Recommendations

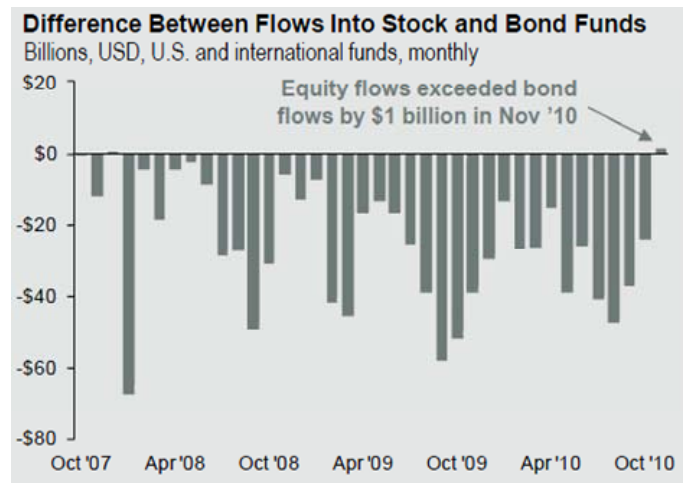
It goes without saying that capital allocation is difficult in an environment with a near term flood of liquidity and overarching concerns in the longer term. As always, all recommendations should be sized appropriately for one’s risk tolerance, liquidity needs, and long term goals.

With the economy improving and the Fed printing money, it is hard not to want to own equities over bonds. Despite the large move from the low in March of 2009, US equities are not that expensive by historical metrics as seen below:

S&P 500 Index: Valuation Measures				Historical Averages			
Valuation Measure	Description	Latest	1-year ago	3-year avg.	5-year avg.	10-year avg.	15-year avg.
P/E	Price to Earnings	13.1x	14.3x	13.0x	13.7x	15.6x	17.2x
P/B	Price to Book	2.3	2.2	2.2	2.4	2.7	3.2
P/CF	Price to Cash Flow	8.7	8.9	8.3	9.2	10.6	11.2
P/S	Price to Sales	1.3	1.2	1.1	1.2	1.3	1.5
Div. Yield	Dividend Yield	2.0%	2.0%	2.3%	2.2%	1.9%	1.9%

Source: JP Morgan

It should be noted that the price to earnings (PE) ratio used in the chart is based on projections for 2011. On a trailing basis, the PE is still only 15 times or slightly below the 60 year average of 15.8. The other metrics hold up favorably compared to the longer term averages. So we would conclude that equities are attractive but only if bond yields behave and corporations are able to maintain record high margins in the face of rising cost pressures (i.e. are able to meet earnings estimates). We continue to favor dividend oriented equities, as we are in the time of the market cycle when these stocks tend to outperform. In addition, fund flows have begun to favor equities over bonds for the first time in roughly three years:



Source: JP Morgan

Regarding emerging equities, we acknowledge that rising interest rates and inflation cause headwinds for their markets but feel that the opportunity warrants a longer term view. Thus, averaging into weakness remains a favorable long term strategy.

For fixed income, we continue to recommend a barbell strategy that favors the shorter end of the curve. The Fed has openly communicated their desire for a higher level of inflation, and commodity prices are already reflecting the looser stance. The municipal market has been in the news lately with one noteworthy analyst calling for hundreds of defaults at the local municipality level. Like any market of its size (the municipal market is roughly \$3 trillion), there are good and bad bonds and we are comfortable that a creditworthy portfolio can be constructed in the space. If anything, the recent selloff has presented an opportunity, especially at the long end, where a significant rise in rates has already been discounted. Further, many municipal funds have been forced to sell their most liquid bonds to meet redemptions, causing pricing pressure on quality bonds.

We continue to recommend opportunities that offer yield and inflation protection as well as strategies that can make money when volatility again picks up. To that end, cash flow real estate is still a recommendation as is an allocation to long/short strategies in equity and credit.

As always, we thank you for your trust and confidence. Please call with any questions or comments.

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