

What should you expect for 2011?

2010 Year End Market Performance*

S&P 500
15.06%

Dow Jones
14.06%

NASDAQ
18.02%

MSCI EAFE
YTD 7.75%

BarCap US
Aggregate Bond
YTD
6.54%

Morningstar
Large Cap Core
12.93%

Morningstar Mid
Cap Core
26.46%

Morningstar
Small Cap Core
27.77%

**Market Data supplied by Morningstar. All returns are with dividends reinvested.*

In my career I have had the opportunity to read a ridiculous amount of prognostications from economists, chief investment strategists, and analysts. That alone has given me a clear understanding of what is expected of me when I write these quarterly reports, especially when it is a year end review. As such, let me give you the end of the story first and then the reasons why after.

Prediction

First, a caveat, always: I will avoid numerical predictions in this edition because it is really important to understand the underlying reasons why markets move. Market cycles are not defined by calendar years but rather economies. Understanding how macroeconomics affects your portfolios will be much more advantageous than series of guesses. What I will do, however is give you a reading on the current economic indicators and then offer an explanation to their relevance to this next year. **That said I believe that the market is poised for a very good gain in 2011 but not without the real potential for a short term pullback.** This short term pullback, however will allow for repositioning of assets to move to undervalued sectors. Also, there will be a mean reversion (money will move from bonds to stocks) which will expand the strength in the stock markets.

Jobs – This is an important indicator so it gets a bit more press!

The strength of consumer spending has to start with employment. You can argue that jobs are just one point on an economic cycle but the one we are in now places job creation as the key to the strength, depth, and length of a strong economy. It is true that in December we added only 103,000 jobs. It is also true that the .4% drop in the unemployment rate (to 9.4%) had more to do with workers just giving up on looking for a job as opposed to finding them. The average hours worked by a current employee is rising steadily, which is a precursor to a decrease in unemployment; a good sign.

Economic Indicators – Here is a short list of some of the economic indicators we are using to help us get a more accurate handle on the future forecast for the direction of the economy:

Indicator	Positive/Negative	Meaning
Consumer Spending	Positive	Consumer spending leads to higher corporate profits
Diffusion Index	Positive	Positive economic indicators minus the negative
Credit Conditions	Positive	Consumers and corporations willing to borrow
Inflation	Positive	Low inflation is positive for market advancement
Unemployment	Positive	Job strength leads to consumer spending
Real Estate	Positive	Lower real mortgage rates lead to RE activity
Consumer Sentiment	Negative	Sentiment is quite favorable: a contrarian indicator
Mutual Fund Flows	Positive	Fund flows have begun to favor equities
PE Ratios	Positive	Real inflation adjusted PE ratios are low – 13 vs. 18
"Smart Money"	Negative	Large traders are thinking the market is overpriced

Explanations

All of the work Bernanke and staff have done has been in an effort to ward off deflation while trying to stimulate the economy. The two rounds of quantitative easing (injecting dollars and keeping rates low) have had a delayed effect. Simply put, the money in the system did not cause the velocity (the rate that money is used in the economy) to increase. With these numbers above it appears that it is finally starting to happen. It is easy to understand that when people work more and feel better about the future they spend more. When they spend more it leads to higher corporate profits and expansion, when the economy expands the markets grow.

The positive indicators listed above are positive in varying degrees. Consumer spending, unemployment rates, and real estate have all shown just modest increases whereas credit conditions, real mortgage rates, and inflation are all quite positive. Indicators are just that, they hope to define a reasonable path to an occurrence; in this case a sustainable economic recovery. The negatives listed above demonstrate that markets don't just always go up in a straight line; they have retrenchments along the way. What these may indicate is that there may be a short term correction of some substance.

Overall, I expect the markets to have a very good year on the average, but it will be very important to be active in managing the portfolios. You must take profits along the way, reposition the investments when the markets dictate, and avoid potentially dangerous sectors such as certain bond positions. This will be an active year for portfolio management, staying aware will be crucial, and we are well on our way.