Market Overview, December 31, 2011

The fourth quarter was a nice improvement from a very negative Q3, with the markets ahead more than 11%, recouping much of the Q3 losses experienced. Worries about sovereign debt issues in Europe, particularly Greece, somewhat faded away as a relatively strong Q3 earnings season overshadowed these issues. The third quarter was the tenth consecutive quarter where actual S&P 500 earnings exceeded the consensus. The fourth quarter is the eleventh consecutive quarter where the actual number beats the consensus number. Treasury bond yields were roughly flat during the quarter staying below 2% on the 10-year Treasury bond. The Federal Reserve retained the Fed funds rate at essentially zero during the quarter, only reinforcing the low interest rate environment, and in fact basically said that they would keep the Fed Funds rate near zero through 2013. One would think higher yielding equities might prove attractive in such a low yield environment. The earnings strength we saw for Q4 could, in our opinion, result in a solid move up in the markets early in the year. After that point, market conditions may become more difficult due to our anticipation for a pullback in profit margins, anti-business rhetoric due to the Presidential election and continued problems in the European Union. For the quarter the markets were solidly higher with the S&P 500 rising 11.2%, while the Dow was up 12.0%, and the NASDAQ jumped 7.9%. For the year, the Dow was up approximately 6%, the S&P was flat and the NASDAQ dropped just over 1%.

The fourth quarter trading activity was much more positive than what we experienced in Q3, as the uncertainty among investors about the economy as well as the situation in Europe was somewhat offset by the relatively strong earnings results. Recent economic statistics continue to indicate a very lackluster (at best) recovery and no double dip recession. Appropriate government actions, combined with a solution to the European issues could send the growth rate higher as companies and consumers become more optimistic and spend and invest. The fairly reasonable valuations in the market, with the S&P 500 trading at approximately 12.5 times 2012 projected earnings and well below traditional valuation metrics, would seem to offer a compelling reason to invest, especially in the current low interest rate environment.

We are of the opinion that equities remain the place to be over the next couple of months. As the markets move up towards the 1350 area on the S&P 500 driven by strong Q4 earnings, which we anticipate will occur later in Q1, we would suggest beginning to reposition some of those equity holdings into fixed income investments. We suggest looking at some higher yielding fixed income investments. Should we get the sell-off we anticipate related to continuing problems in Europe, business-negative rhetoric in the Presidential election and a compression in profit margins, this could create an excellent buying opportunity later in the year as we expect valuations to become more attractive and allow us to jump in at excellent prices. Remember, one should always hold a portfolio exposed to all asset classes, and our suggestion is to over weight equities versus bonds early in the year, and reverse that exposure as equity prices rise, underweighting equities by quarter end. Having said that, after the election, we expect we could very well see an explosive move to the upside that could push the S&P 500 above 1500 as the issues in Europe get straightened out, the political machinations come to an end and the economy continues its slow improvement.

John Roberts, Director of Research, December 31, 2011