2011 Investment Strategy and Outlook

2010 – Financial Markets in Review

- All major asset categories gained in 2010
- After the second quarter selloff, stocks end up 12%
- Tax bill looks to be good for stocks, bad for bonds

In looking at the final results for 2010, it was a good year as all major asset categories produced respectable returns. However, looking closer at the details of the year it included a lot more drama than the 13% return on the Dow Jones Industrials would suggest. The year got off to a good start with stocks and bonds advancing during the first quarter.

The financial markets experienced the first major correction since the bottom of the bear market in March 2009 in April 2010. During the second quarter the equity market fell sharply as investors became concerned about the sustainability of the economic recovery subsequent to the European debt turmoil and the BP oil disaster. Markets finally stabilized in August despite negative investor sentiment as many investors were concerned that the financial markets were about to fall to the lows experienced in 2009. The Federal Reserve effectively leaked rumors of a 2nd round of actions to stabilize the bond market by purchasing various Treasury bond issues, now known as quantitative easing 2 "QE2." The rumors combined with other good news, helped start a rally in stocks and bonds that lasted until November.

The fourth quarter concluded with excitement with an agreement on a new tax bill which saw President Obama and Congress actually agreeing to give the other party their wish list. Republicans got an extension of current tax rates and very favorable estate tax provisions, while Democrats got an extension of unemployment benefits for another year. The bond market was not so quick to applaud the $853 billion tax bill, as yields shot up leading to the one of the worst sell offs in bonds in years. Conversely, commodities markets cheered the potential pickup in consumer spending leading metals and energy prices higher.

As 2010 came to a close, commodities were the biggest gainers, followed by stocks, and despite the fourth quarter flop, bonds still put an up good gains for the year. Even the US Dollar was a bit higher than a year earlier.

Capital Market Outlook:

US Dollar: Stabilizing to increasing relative to foreign currencies

Commodities: Generally trending higher, but at risk to rising dollar

Bonds: Generally yields trending higher, until Fed policy changes

Stocks: Late stage rally continues in early 2011, spring correction a possibility

Primary Client Objective: Produce consistent long term returns while avoiding unreasonable risk.

Strategy to Achieve Client Objective: Combine technical analysis (investor psychology, charting) with fundamental analysis (economics and accounting) to identify the most attractive markets, sectors, and securities to achieve returns while avoiding risk.

Economic Outlook – *Recovery to Expansion*

- Can the economy grow without government help?
- Manufacturing is showing surprisingly strength
- Employment and real estate will be the last sectors to improve

Since the economy bottomed out in 2009, investors have been concerned if growth could be sustained in the absence of government fiscal and monetary stimulation. 2011 will most likely provide insight as to the sustainability of economic activity. 2010 finished the year on generally positive news of the best holiday retail sales since 2007, solid industrial activity, and moderate inflation. One of the best indicators of activity, but little noticed indicators, is electric power production with is up close to 4% over 2009. While the economy in 2009 was stabilizing, in 2010, the economy was recovering, and in 2011, the economy may be in an expansion mode.

The economic momentum in late 2010 should carry forward into the New Year. Activity appears to be most notable in the manufacturing sector. Demand for more domestically manufactured products appears to be surprisingly strong, and is most likely due to foreign buyers, resurging auto manufacturing, and infrastructure rebuilding. The uptick in business activity will help to solve the high rate of unemployment and real estate market debacle over time. Businesses do not hire until they are beyond the capacity of their current workforce, which is not the current case. The extension of unemployment benefits and the new healthcare bill are issues that may be holding back expansion of the workforce.

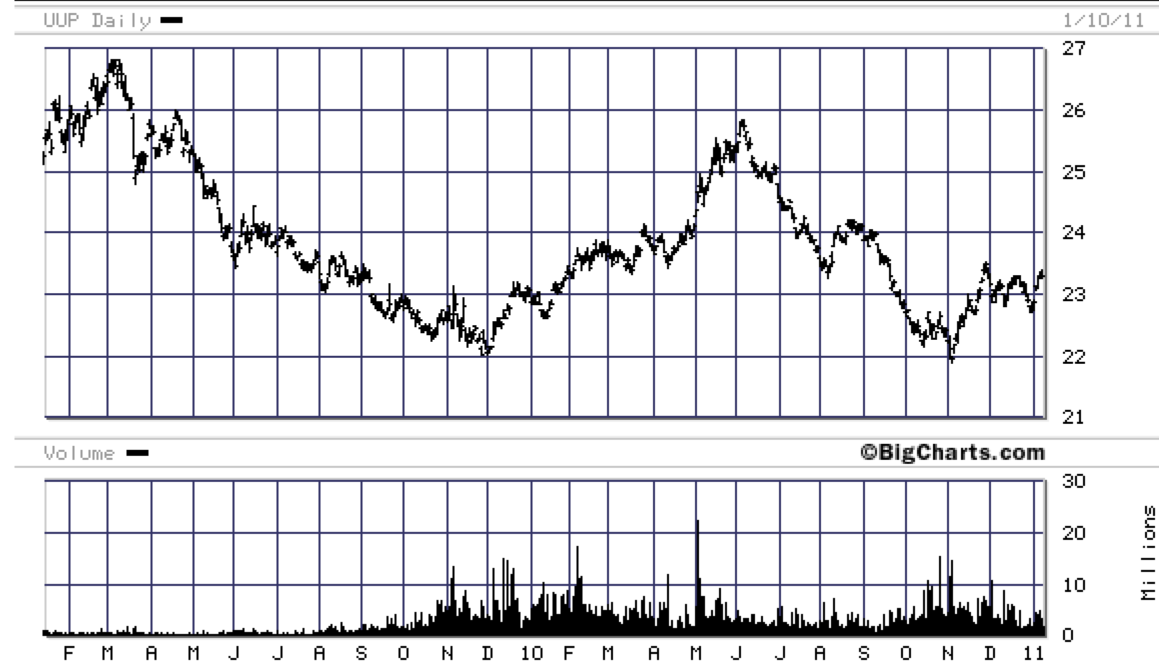
<u>Capital Market Outlook</u>

U.S. Dollar Outlook

- A decade long decline is now stabilizing
- Key question – can the economy improve without a falling dollar?

The US Dollar heavily influences the economy and other financial markets. For the past decade, the US Dollar has lost value relative to foreign currencies. Travelers abroad are well aware of this situation. As the chart below shows, the long term decline in the dollar appears to be stabilizing and maybe approaching an intermediate term rally. The catalyst for a rising Dollar may occur from higher interest rates attracting foreign capital and growing domestic economy.

UUP PowerShares DB US Dollar Bullish Fund 1/10/2011 3:20 PM

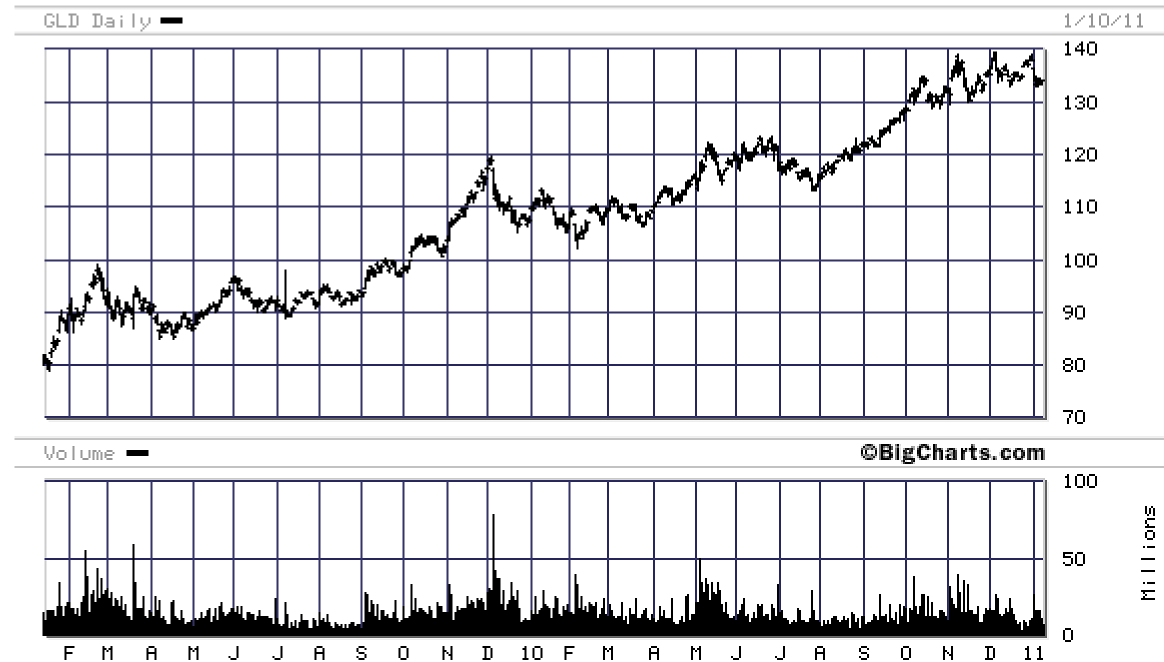


Commodities Outlook

- Commodities were the best performing asset category in 2010
- US Dollar strength poses a risk to commodities
- Sentiment is excessively bullish towards commodities, especially metals

Commodities rose in 2010 due to rising demand and a falling US Dollar. With the economies worldwide accelerating, the demand for commodities is expected to increase. Since a falling currency tends to stimulate economic activity since goods would be "on sale" to foreigners, commodity prices often react positively. Thus, if the Dollar rises this year, the reaction in the stock market, commodities markets, and the economy will be watched closely. If the US Economy is strong enough, the falling dollar may no longer be needed to stimulate activity.

GLD SPDR Gold Trust ETF



Fixed Income Outlook

- Tax bill sparks 4th quarter bond market selloff
- 10yr Treasury bond yield trending to 4% from 3.5%
- Muni bond mutual funds wacked as investors pull out leaving select opportunities for tax free income
- Corporate bonds with a "B" in their credit ratings remain attractive

Fixed income investors have not viewed the recent tax bill favorable in the short term. While QE2 was well received by the bond market as yields trended lower through the fall, the tax bill and its $853 Billion price tag was too much to digest for bond investors, as evidenced by the sharp rise in the 10 year treasury bond from 2.5% to 3.5% from November to December. While corporate bonds generally fared better, the Municipal market was trounced as investors yanked out billions of funds from tax free bond funds due to the extension of current tax rates and concerns over state and local government finances.

Looking forward, we expect a trend of higher interest rates. The expanding economy coupled with the large and growing Federal debt, suggests the path of least resistance is for intermediate to long term interest rates ticking up ½% to 1%. The 10 year Treasury looks to be heading for a 4% yield. However, once the Federal Reserve hints of raising short term interest rates, long term interest rates could stabilize and make purchase of longer term bonds attractive later in the year.

10 year Treasury Bond Yield

We believe bonds with maturities from three to six years are the most attractive balance between yield and protection from rising interest rates. Further, corporate bonds with credit rating under “A” rating also offer attractive yields as many investors cannot purchase bonds with a “B” credit rating. In addition, convertible issues and high yield bonds offer opportunities to mitigate the impact of higher interest rates. For investors seeking tax free income, municipal bonds are offering extremely attractive yields. While some state and local governments are experiencing financial challenges, the expanding economy and the historic low default rate makes select municipal bonds attractive.

Equity Outlook

- Stock market is in the later stages of an intermediate term rally
- Sentiment is overly bullish, upside potential limited, but momentum is carrying prices higher
- Economically sensitive sectors including energy, materials, and financials are most attractive
- Strategy: hold current positions with an eye to a potential correction

The equity market begins 2011 with strong momentum after over 20% gains in the second half of 2010. In developing expectations for the equity market, valuation, trend analysis, and investor sentiment are evaluated. The fundamental analysis of the equity market suggests a moderate appreciation potential. Argus Research indicates upside potential of 15% to 20%, while Value

Line Investment Survey is less optimistic in projecting upside appreciation of 45% over the next 3 to 5 years. Conversely, this same Value Line index was projecting 85% potential returns this past summer. The big question is how much of the recent stock market rally has already discounted the improved economic conditions now being reported.

Technical analysis suggests a similar outlook of limited upside potential, however the prevailing trend is up, so no need to reduce equity portfolio weightings until further evidence of a change in direction is confirmed. Market advances tend to follow a three phase process. The present equity market bull market began last summer with the first phase with a market bottoming process. The next phase was the major advance which was characterized by improving economic conditions. This phase began in late August and lasted until the correction in mid November. The third phase began in late November and is still in existence. This phase is characterized by new investors into stocks that have missed the rally to date and are motivated out of fear of missing the rally, rather than sound judgment. This late stage advance is confirmed by the excessive bullish psychology as measured by various sentiment polls. While the current equity market rally is getting tired, the market could continue to appreciate.

SP500 Index

Sector Strategy

As the economy appears to be more stable, economically sensitive sectors will be the focus at this point in the stock market cycle. Specifically, materials, energy, and financial sectors have received increased exposure in client portfolios recently. While material and energy sectors will benefit from higher commodity prices, financials may benefit from higher interest rates, renewed demand for loans, and a recovery from the prior two years of stock market decline. Sectors that

we are less enthusiastic about include consumer discretionary and staples since they did relatively well in 2010 and only offer limited appreciation.

Notable stock selections:

Apple Inc. – One of the most innovative computer companies ever
Mueller Water Products – A small cap stock that is a leader in providing water infrastructure products
Ford Motor 6.5% Convertible Preferred – Auto manufacturer benefiting from a rebound in auto sales led by new models and increased consumer confidence
First Niagara & BBT – Two banks that have taken advantage cheap acquisitions and were quick to raise capital as well as paying dividends
Nucor Inc. – The largest manufacturer of recycled steel in the US
Helmerich & Payne – A technology leader in drilling rigs for oil and gas
Hess Inc. – An integrated oil company with strong environmental policies
Varian Medical – A leader in cancer therapy systems
Applied Materials – A leader in semiconductor equipment worldwide
Gold Ishare – An ETF tracking the price of gold

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Sources of information in this report include Value Line, StockCharts.com, Argus Research, and Telechart.