

# 2011 Economic and Stock Market Outlook

Please refer to Appendix – Important Disclosures and Analyst Certification

## Threading a Needle – With 40 MPH Winds

### 2011 Outlook Summary

Risk on S&P 500 to 1000, Reward to 1400.

Path of least resistance for stocks looks higher into mid year. Second half could see rising headwinds.

GDP growth forecast – H1: 3.0%, H2: 2.0%. Tax breaks/stimulus support consumer spending but housing and employment remain wildcards. Business investment stays strong.

Inflation measures move toward trend, but deflationary threats from heavy debt loads and ongoing de-leveraging process have not gone away.

### Contents:

- **Secular Risks Still Elevated; Deleveraging Process Still Uneven**
- **Economic Fundamentals – Bearish; Labor Market Improvement Lacking**
- **Federal Reserve Policy – Bullish; Increased Liquidity Favorable for Stocks and Commodities**
- **Valuations – Neutral; Little Evidence That a Secular Low Has Been Made**
- **Seasonal Tendencies/Trends – Bullish; Post Mid-Term Elections Trends Favorable Into Mid-Year**
- **Sentiment – Neutral; Near-Term Optimism Offset by Latent Pessimism**
- **Broad Market Trends – Bullish; Most Industry Groups Participating**
- **Portfolio Implications – Tactical Approaches Offer Opportunity**

We don't sew. Not many people do these days. But there are times for us all when we need to re-attach a button or repair a hem. Often times, it seems like the most difficult part of the whole process is just getting the thread through the eye of the needle. Threading a needle can be difficult enough inside, in a room where the air is hardly moving. Now imagine throwing open the windows, or stepping outside into a wind storm, and attempting it. That is our metaphor for investors as we put the finishing touches on 2010 and looks toward 2011. The needle needing threading – well that's an investor's portfolio. The cross breezes are the unabated secular concerns, and the cyclical evidence that suggests that the path of least resistance for stocks could be higher into mid-2011. The interplay of these inconstant and often competing forces suggests that 2011 may be a year of delicate balances and shifting trends.

### The Cross Breezes (Secular Risks and the Weight of the Evidence)

Secular risks remain high. Debt levels are still excessive and the risk of deflation is still elevated.

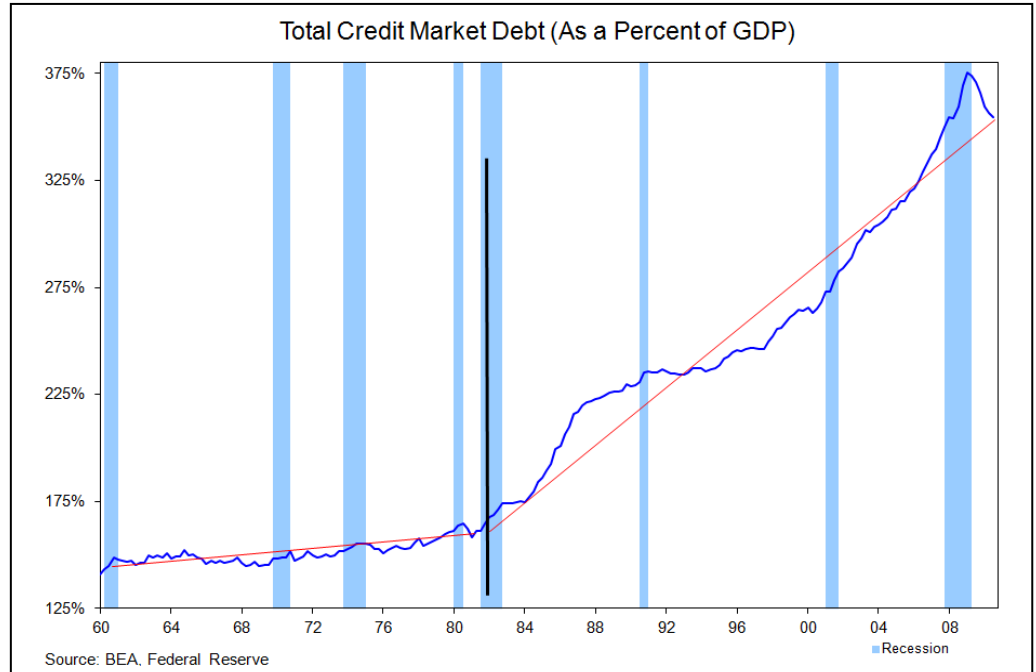
The debt bubble, now widely recognized as the problem, appears to have peaked. A comprehensive solution remains somewhat intractable and the process of returning to more sustainable levels has barely begun. Households are paring back their debt levels, although data from the Federal Reserve suggests that the improvement in household balance sheets has been as much due to defaults as debt pay-downs. Either way, though, *at the household level debts are being destroyed*. We have now seen 10 straight quarters of declining household debt levels.

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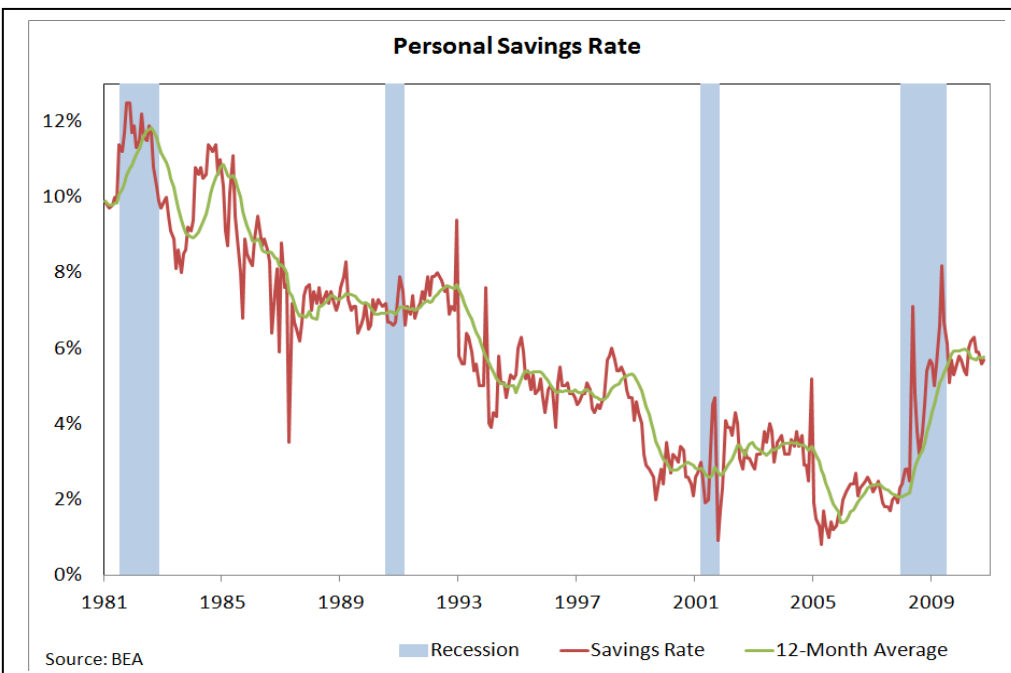
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Associated with these efforts to reduce debt levels has been a rise in the personal savings rate and the beginning of a shift from a borrow-and-spend economy to one that derives its growth from business investment. The savings rate, which is the spread between income and spending (meaning it makes no distinction between savings and debt reduction), has moved from zero just a few years ago to as high as 6%. The long-term trend is 8%, suggesting that more work needs to be done in this regard. The other positive secular development is that **personal consumption, as a percent of total economic activity, is receding and business investment is expanding sharply.**

The process of secular improvement being seen at the household and business level is **not** being echoed by the government. In fact, government debts levels have moved in the opposite direction. Federal debt has expanded at a double-digit rate in each of the last nine quarters, rising 16% in the latest quarter. The expansion in debt has fueled the expansion of federal government spending, which now tops 25% of total GDP. The



composition of this spending (of which over the last 12 months, 33 cents of every dollar was financed by borrowing) is what helps make this problem so difficult. Half of all federal government spending is now on net interest and entitlements (Social Security and Medicare). Fifty years ago, those categories accounted for less than 20% of federal government spending. **We now spend nearly as much financing our debt as we do on national defense.** The long-term solution is unclear, but these recent trends can clearly not persist.



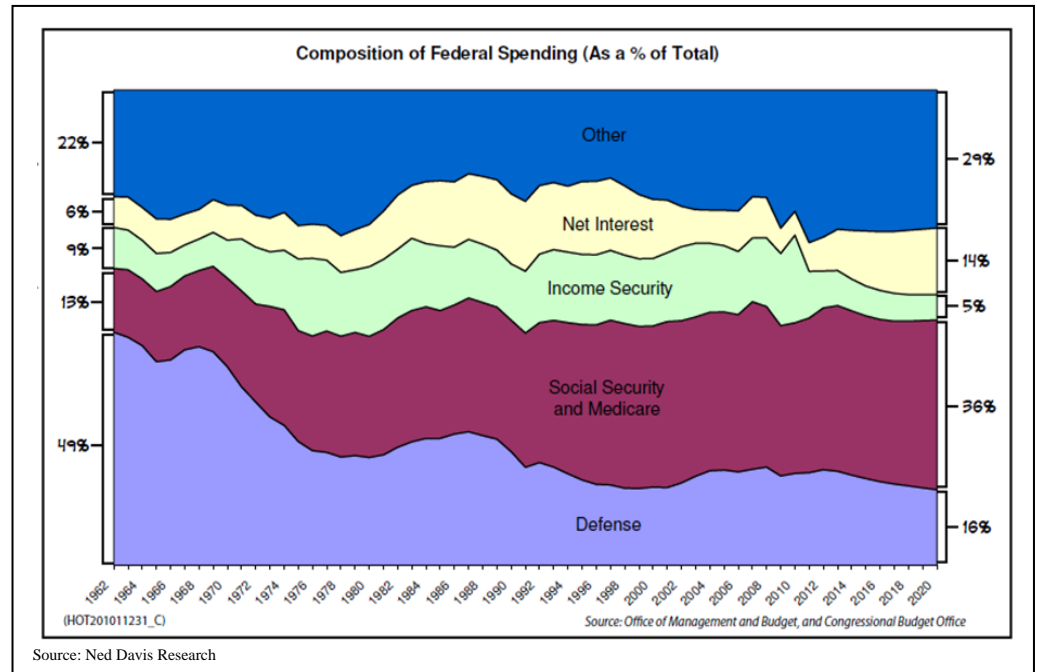
The bailouts/stimuli done both domestically and internationally over the past two years have been largely a form of bridge financing. At the private sector level, companies have been able to make substantial improvements and rebuild their foundations. At the government level (state and local municipalities in the U.S. and various members of the E.U.), little has changed and financing is running out. **The return of more normally functioning financial markets allowed policy makers to avoid hard choices even though underneath the surface little**

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had changed. We will continue to deal with financial flare-ups and spikes in yield spreads and CDS spreads until real changes are being put in place. The hope is the policymakers in Washington DC learn from the lingering risks in Europe and move to take proactive steps toward a surer foundation.

The necessity of clearing debts from balance sheets is one of the clear messages of the Japanese experience of the last 20 years and a truism about economic cycles. **Recessions serve to clear the excesses of the previous expansion and the secular expansion of the past generation was fueled by the excessive accumulation of debt.** These debts levels must be significantly relieved before we can have confidence that secular risks are fading and the foundation for the next secular expansion has been laid. The exact degree of relief that is needed is uncertain, although a retreat to the levels seen in the mid-1990's might be sufficient. *What seems likely though is the resolution of excess is unlikely to occur at a long-term median. This process*



*may be more protracted and require more patience than is now appreciated.*

### Weight of the Evidence

While these secular forces blow with unabated fury, favorable trade winds offer support for stocks into the middle of 2011. Our summation of the weight of the evidence, which we review in detail in the following

pages, shows that **the path of least resistance for stocks is higher and that there is yet little evidence that the cyclical upswing that began in March 2009 has run its course.** Our weight of the evidence approach to the stock market looks at the underlying fundamentals as well as the technical influences – *striking a balance between what could happen and what is happening to stocks.* As we move into 2011 the weight of the evidence is bullish, supported mainly by strong technicals. From a fundamental perspective, bearish economic fundamentals are offset by bullish fed policy, with



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valuations being neutral. From a technical perspective, sentiment is moving toward excessive optimism, but for now is still neutral. Our breadth indicators and the seasonal patterns/cyclical trends are both bullish. **Altogether, this suggests that stocks could work higher into mid 2011, it is in the context of an aging cyclical rally within an ongoing secular bear market.**

### Economic Fundamentals

More than a year after the most recent recession ended, the economy remains on uncertain footing. Much of the growth in the early stages of the recovery was driven by government stimulus, either direct spending or indirect incentivizing (think "Cash for Clunkers"). As these programs faded, growth stalled. Consumers were either unable or unwilling (most likely a combination of the two) to take the baton. **Job growth has remained meager, housing is still struggling to find a bottom, concern is rising that the build in business inventories (a positive contribution to current GDP growth) has not been entirely welcome, and the Federal Reserve is**

## Indicator Review

### Fundamental Factors

Underlying Economic Fundamentals	Bearish	-1
Federal Reserve Policy	Bullish	+1
Valuations	Neutral	0

### Technical Factors

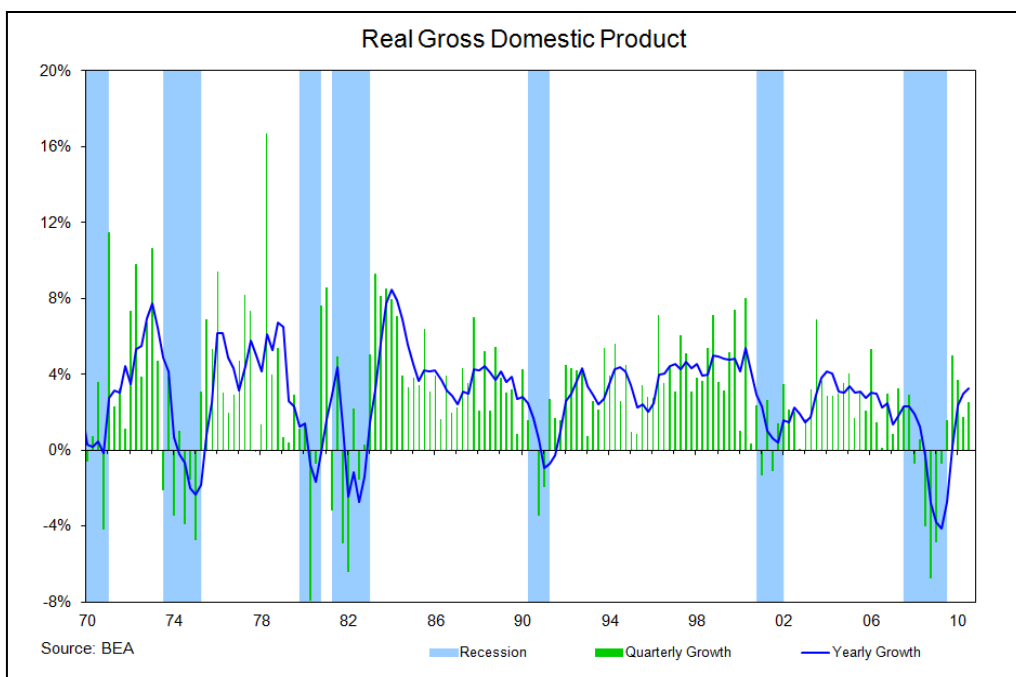
Investor Sentiment	Neutral	0
Trends/Seasonal Tendencies	Bullish	+1
Tape/Breadth	Bullish	+1

### Weight of the Evidence

Bullish +2

**sufficiently concerned about deflation that it has undertaken yet another round of balance sheet expansion.** *We see little evidence that the excesses of the past cycle have been unwound.* While the increasing awareness of the need to address unsustainable debt loads (at both the household and governmental level) is a positive development from a long-term perspective, this process is in its early stages and the economy remains in transition. Another positive (albeit early stage) development for the economy has been the secular shift away from rampant consumerism and toward increased business investment.

**Household Sector:** The recently arrived at compromise on taxes and other stimulus measures removes some measure of uncertainty for the household sector for 2011. While the compromise keeps intact existing tax rates/credits, it also extends unemployment benefits through 2011 and lowers the social security tax paid by workers by two percentage points. The extension of unemployment benefits and the social security tax cut could provide

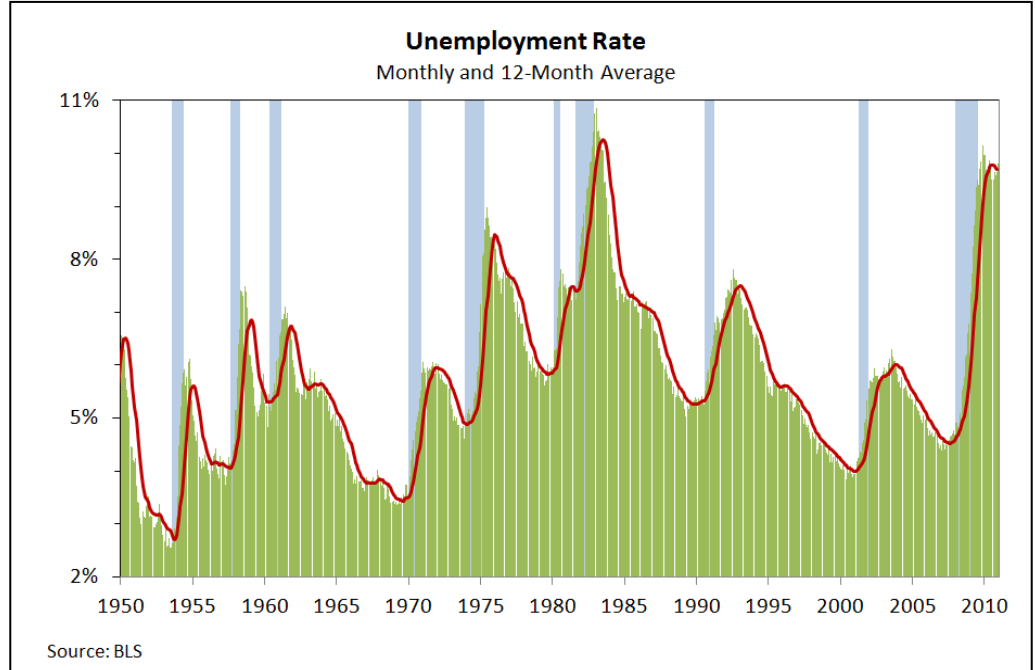


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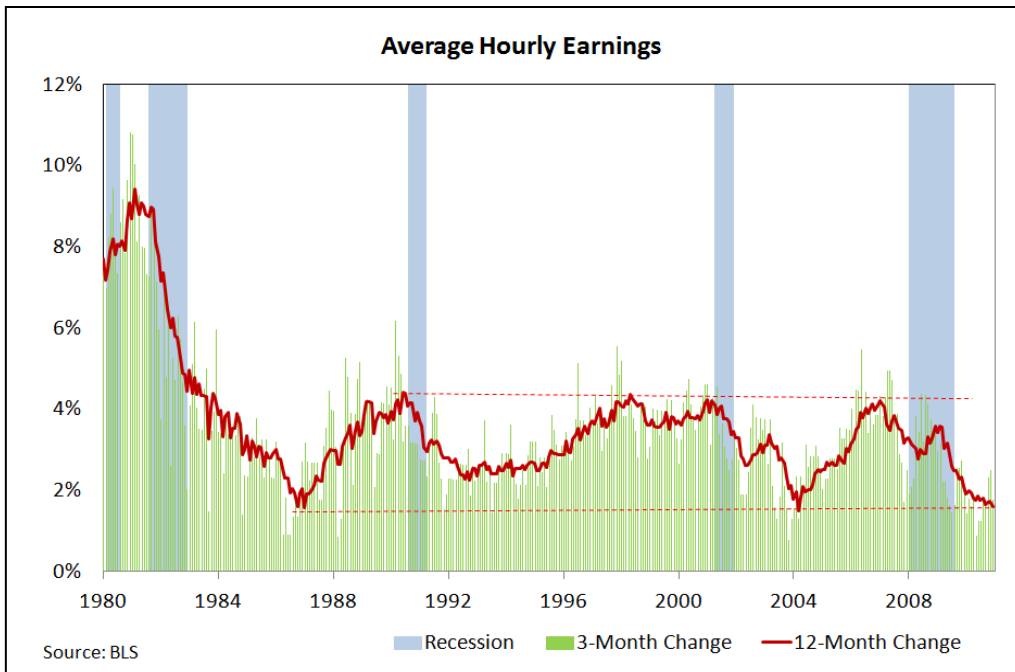
an unexpected boost to household sector activity in 2011. These are temporary measures, and while helpful at the margin, they do not dramatically change the upside potential for the economy going forward. **Sustainable and lasting gains in the household sector will come only as labor market conditions improve and housing stabilizes.**

Labor markets improved somewhat over the course of 2010, and continued modest payroll increases are likely to be seen as we move through 2011. *Unemployment remains stubbornly high, however, with more than 15 million Americans fitting the official definition – out of work and actively looking for a job.* This corresponds to a 9.8% unemployment rate – a level that rises above 17% when discouraged workers and those who are working less than they would prefer are included. The official unemployment rate could move back above 10% in early 2011 as discouraged workers move back into the labor force and if payroll increases are too lackluster to absorb these increases. It is estimated that it requires between 100,000 and 150,000



new jobs per month to absorb new workers into the economy and not see an increase in the jobless rate.

Organic income growth is largely dependent on two factors, the number of people with jobs as well as the wage they earn. Not only has job growth been paltry (the first 11 months of the year saw on average fewer than 90,000 new jobs per month), but wage growth has slowed. Average hourly earnings were up 2.1% in the 12 months ending November 2009, but were up only 1.6% in the 12 months ending November 2010.



An increasingly large contributor to overall income growth is net transfers from the government (social security and as well as jobless benefits). **Better than 10% of total personal income now comes from government transfers.** While influenced by the current economic fragility, the current peak is nearly twice as high as the past recession-related peaks. *If this trend continues, it would represent a loss of vibrancy in the U.S. economy and may represent a shift away from the dynamic, entrepreneurial-driven economy that we have*

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associated with the American experiment.

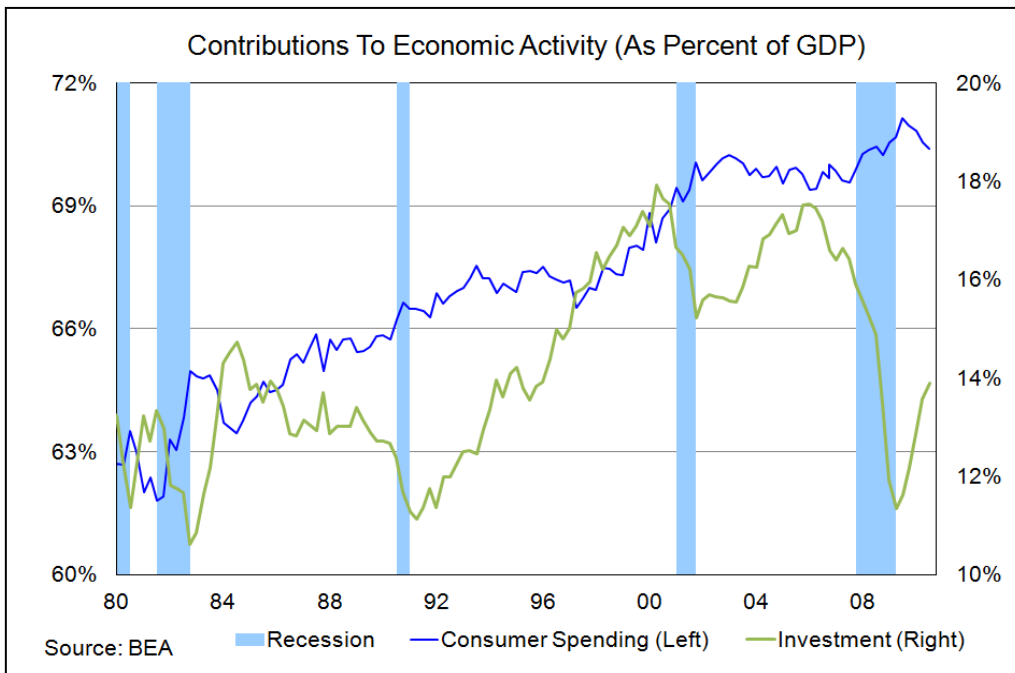
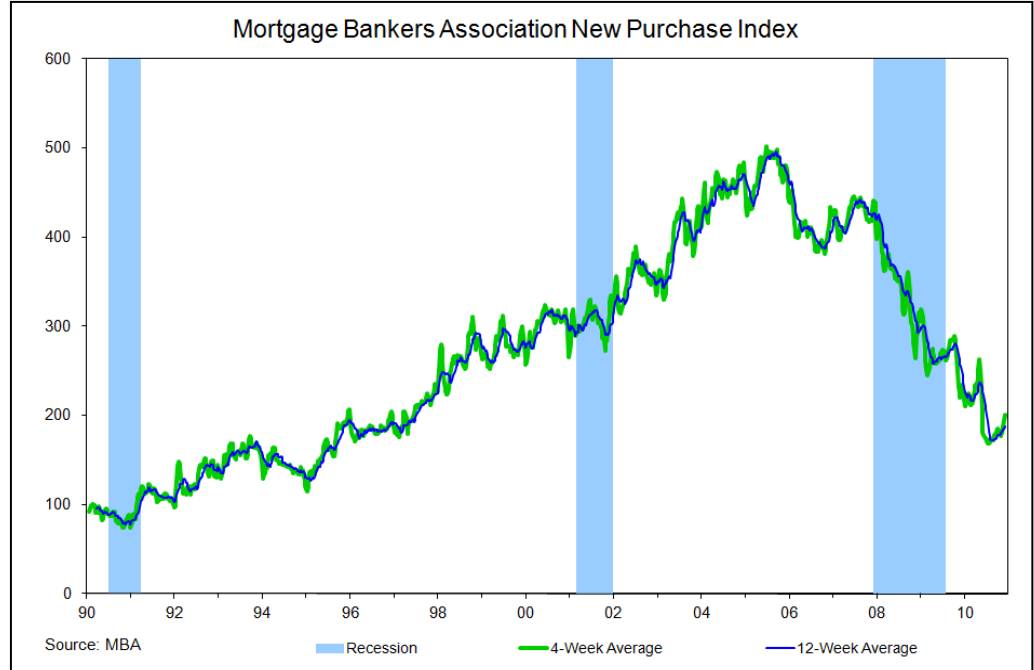
Housing continues to struggle to find a bottom even with record low mortgage rates. Mortgage refinancing activity was strong for much of 2010 as existing homeowners took advantage of these low rates and reduced their monthly financial obligations. Home buying and residential construction have remained weak in 2010 and are likely to remain so in 2011. Our below-consensus forecast for economy growth in 2011 rests in part on a more cautious view of the housing market and its ability to offer a positive contribution to GDP in 2011. **There is little evidence that the downward trend in housing market activity has been broken,**

and with so many homeowners currently underwater on their mortgages the pool of home buyers is reduced. Moreover, with the supply of homes for sale outpacing demand, there remains downward pressure on prices and little incentive to build new homes.

**Business Spending/Investment:** Business spending has been a source of strength for the economy. Combined, **investments in equipment and software**

**and inventory building have more than accounted for all of the net growth seen in the economy over the first three quarters of 2010.** These may represent two divergent trends for 2011. Investment in equipment and software account for only 8% of overall economic activity, but represent half of the growth seen in the economy in 2010. Growth here may accelerate in 2011, aided by the tax compromise that has been agreed to between the president and the Republicans in Congress which includes a provision for the full depreciation of investments made in 2011.

This may be pulling forward investment that would have otherwise been slated for future years, but *it also accelerates the favorable trend of an economy more driven by business investment and less dependent on consumption for growth.* Business spending also benefits from strong overseas demand. Emerging markets are an increasingly important destination for our exports of business equipment, if not consumer goods. Business spending on structures, which has been a drag on the economy in 2010, may turn modestly higher in 2011.

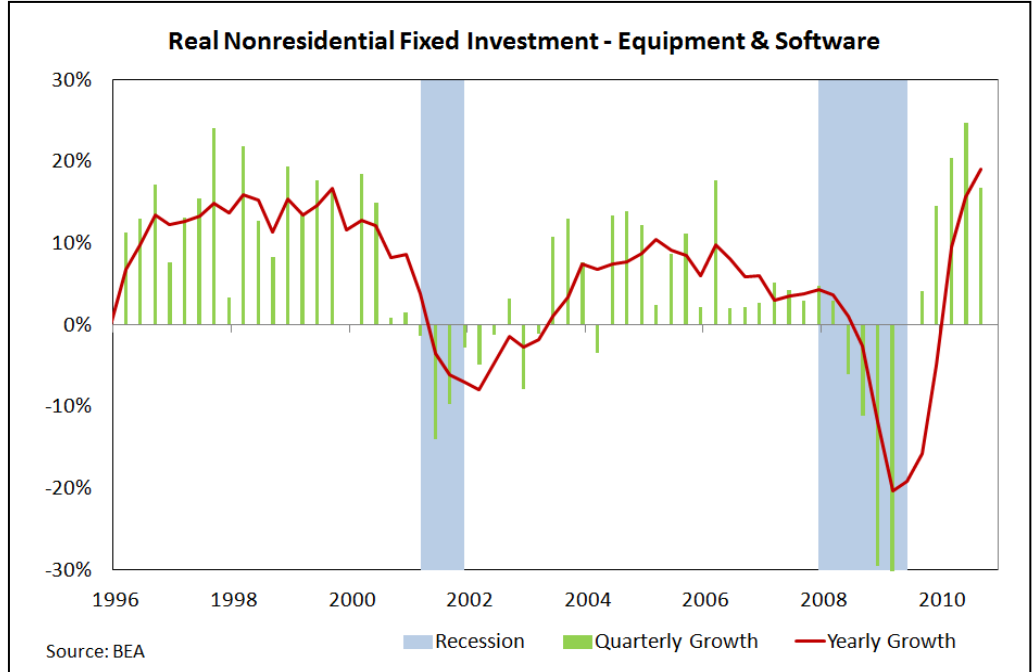


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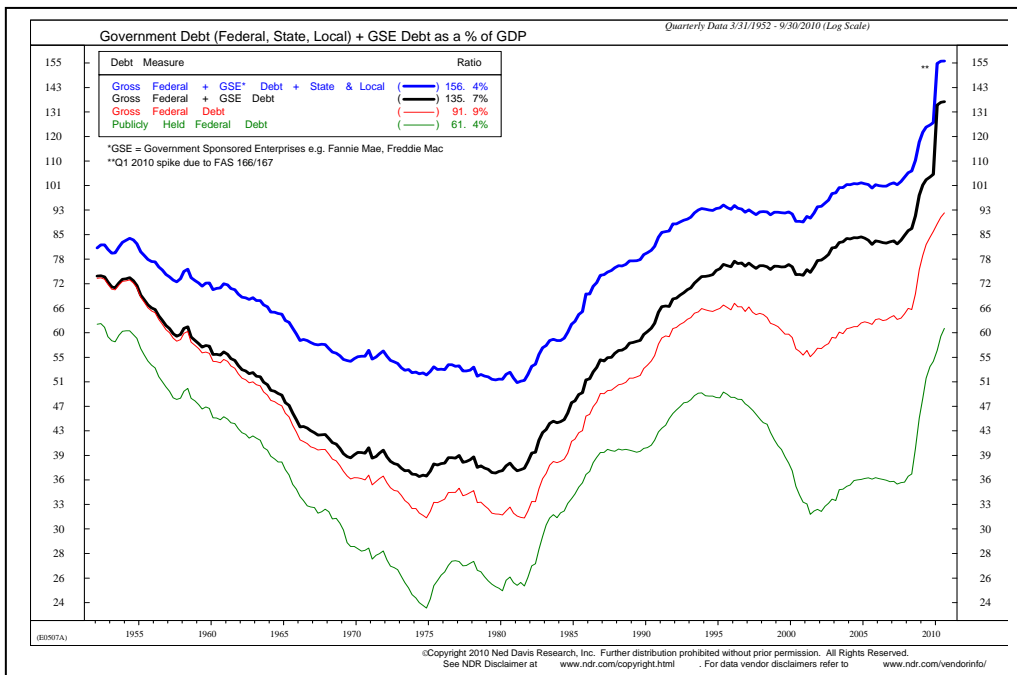
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The risk in business spending may be on the inventory side. Inventories re-building added an average of 1.6 percentage points of growth per quarter over the first three quarters of 2010. While this has certainly been a positive for the economy this year, it is still uncertain how much of this build is desired (i.e., rebuilding depleted stocks) and how much is undesired (i.e., production running ahead of slowing demand). The accounting of inventories in the GDP data requires continued increases in the rate of inventory accumulation to produce positive contributions to growth. A slowing in the rate of inventory accumulation would produce a modest drag on GDP growth in 2011. A continued strong positive contribution to GDP from inventory building in 2011 may be an early sign that end-demand is slipping.

**Government:** As we addressed above, the governmental response to the financial strains of the past several years have been to accumulate more debts, and largely delay any substantive action in terms of balance receipts and outlays. While much of the national



attention to the November 2010 elections has been the Federal results (Republican gains in the Senate, Republican control of the House), there was also a considerable shift at the state and local government, with many of these candidates running on fiscal discipline platforms. If these new elected governors, state senators and assemblymen are taken at their word (always a dubious proposition when talking about politicians), state and local budgets could begin to be slashed. The stimulus package that was passed in early 2009 provided substantial budget relief to states and local governments – essentially bridge financing that is now running out. This may mean that the positive impact to GDP growth from government spending seen in 2010 could reverse in 2011. It also suggests that government payrolls (particularly state and local government payrolls) could meaningfully contract as we move forward. This would put more pressure on a labor market that is already saturated with supply.



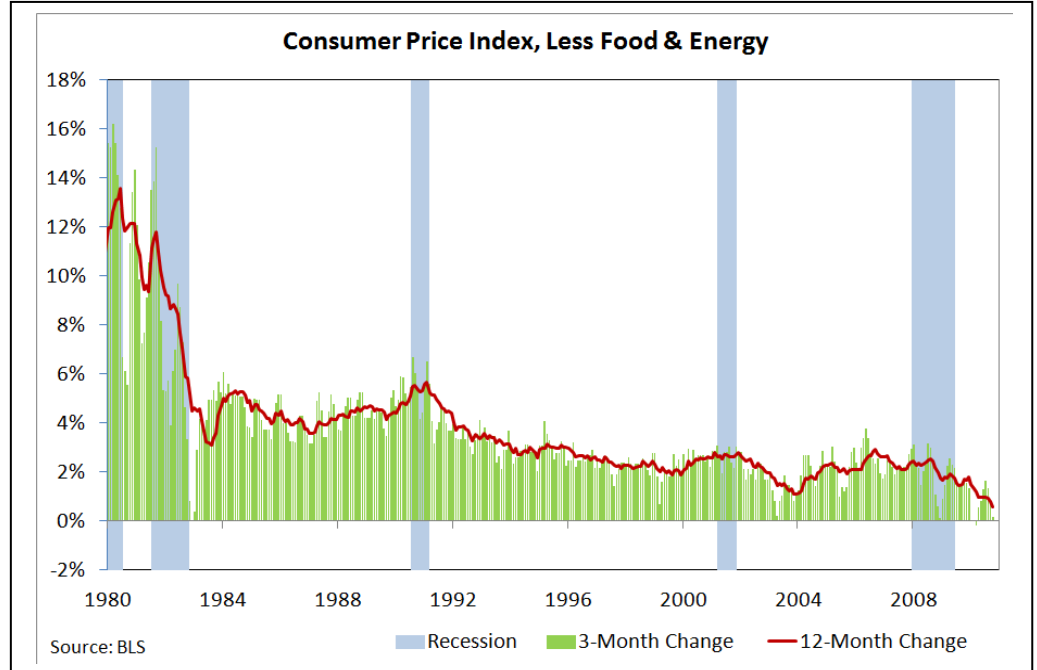
**Inflation:** The outlook for inflation remains benign, although that is not to say that some areas of the economy will not see price increases.

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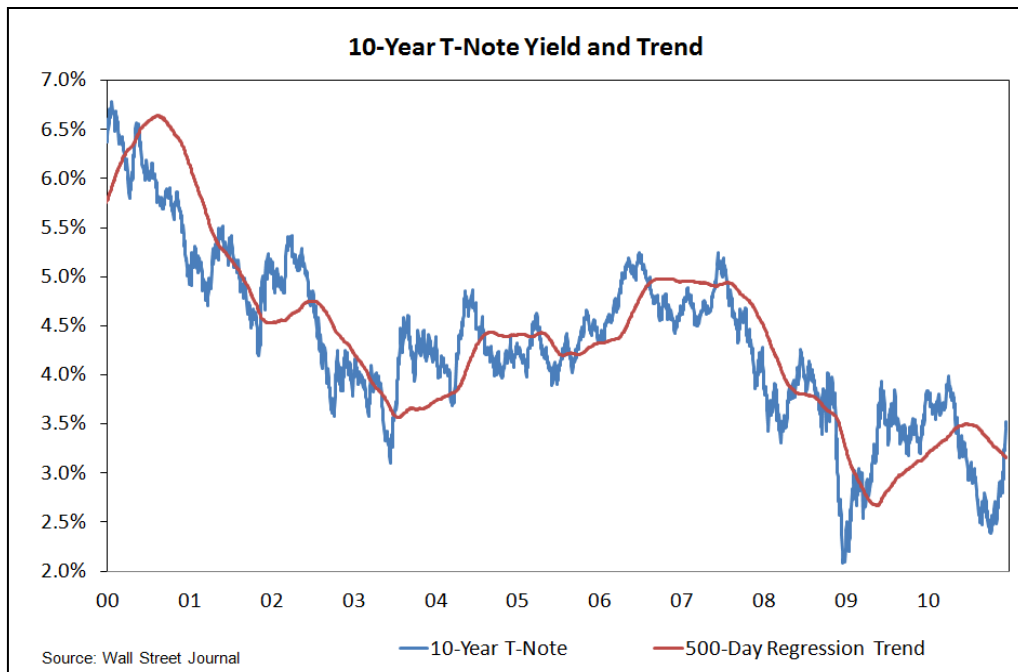
The measures of inflation that the Federal Reserve monitors exclude food and energy prices. These core indexes may provide a more stable reading on inflation (and over time the overall and core inflation measures tend to converge), but they do not accurately reflect changes in out-of-pocket costs. **It is ironic that the categories that are excluded from the "core" measures of inflation are some of the most core purchases we make on a weekly basis: food for our tables and fuel for our cars.** In some ways these higher costs should be viewed more like taxes and less like inflation – they take a real bite out of activity but are unlikely to be met with a policy response from the Fed.

Core inflation, as measured by the consumer price index excluding food and energy, is at its lowest level in at least 50 years. Over the past year the core CPI is up just 0.6% – one year ago it was at 1.7%. Two key forces are helping keep inflation low: the lack of wage growth discussed above, and the deflationary effect of the ongoing de-leveraging process. An improvement in the labor market and an associated acceleration in wage



growth is a likely necessary pre-condition to see sustained inflationary pressures. Along with that, we would also likely need to see a completion of the de-leveraging process that is helping suppress aggregate demand and limiting price increases. If the monetary stimulus that is being pumped into the system by the Federal Reserve moves largely into stocks and commodities, the headline inflation rates (those that include food and energy costs) could move higher over the course of 2011. *We do not expect core inflation to move significantly higher in the coming year, although it may move back toward the Fed's comfort range (1.5% to 2.0%).*

**Bond Yields:** With inflation and inflation expectations likely to remain low, protracted upward pressure on bond yields is unlikely to emerge. The rally in yields seen in the fourth quarter of 2010, which saw the yield on the benchmark 10-year T-Note rise nearly 100 basis points from its October low below 2.40%, does not likely reflect the beginning of a sustainable trend higher in yields. This rise in bond yields began as the bond market bought the rumor (lower



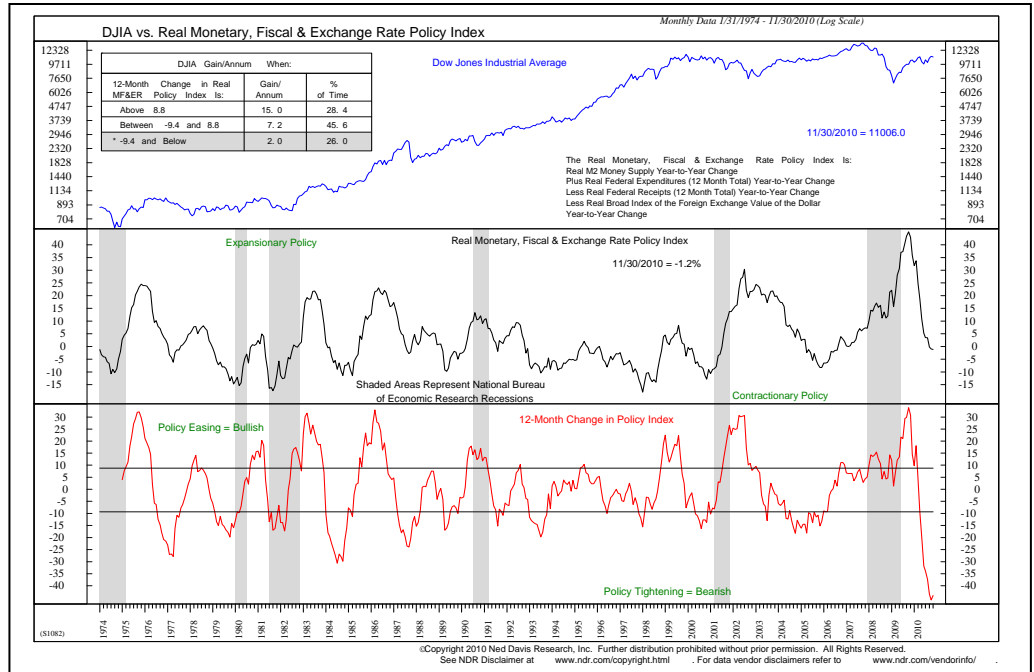
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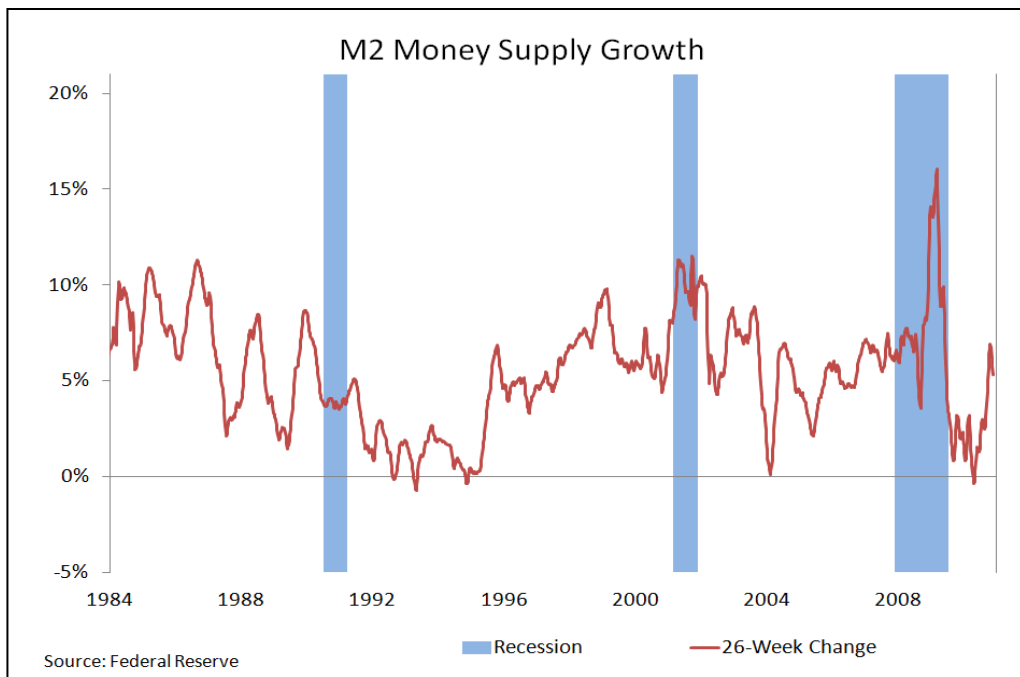
yields) and sold the news (higher yields) of the Federal Reserve's undertaking of a second round of quantitative easing. News of a tax compromise/second stimulus package brought with it renewed concern about elevated deficits and the supply of Treasuries coming to the market. **This current rise in yields is unlikely to persist.** The economy, particularly housing, cannot yet bear the burden of higher interest rates. A further rise in bond yields would likely be followed by a weakening of the economy and hence, lower yields. *While the bond bull market of the past 30 years looks to be in its final stages, it does not yet appear to have run its course.* The yield on the benchmark 10-year T-Note will likely not rise above 4.0% in 2011, and could retest its 2010, and perhaps 2009, lows below 2.50%.

## Federal Reserve Policy

The Federal Reserve began the year seeking to move



away from active and extraordinary involvement in the financial markets. They wound down a number of lending facilities and were poised to allow their balance sheet to contract as existing assets matured. These efforts proved to be too early. Money supply growth stalled, measures of fiscal and monetary policy stimulus turned negative, and overall economic growth slowed from a 5.0% annualized rate in the final quarter of 2009 to just 1.7% in the second quarter of 2010.



The Great Depression in the 1930's was prolonged due to policy error on the part of the Federal Reserve. Monetary policy support was prematurely withdrawn from the economy. In the ensuing vacuum, the economy turned lower and deflationary forces were unleashed. **The current Fed has learned from that episode and is not willing to repeat those mistakes.** The first step was to announce that it would maintain the level of its balance sheet by using principal payments it received to purchase Treasuries. With incoming economic data pointing to both persistently high unemployment and uncomfortably low inflation, the Federal Reserve

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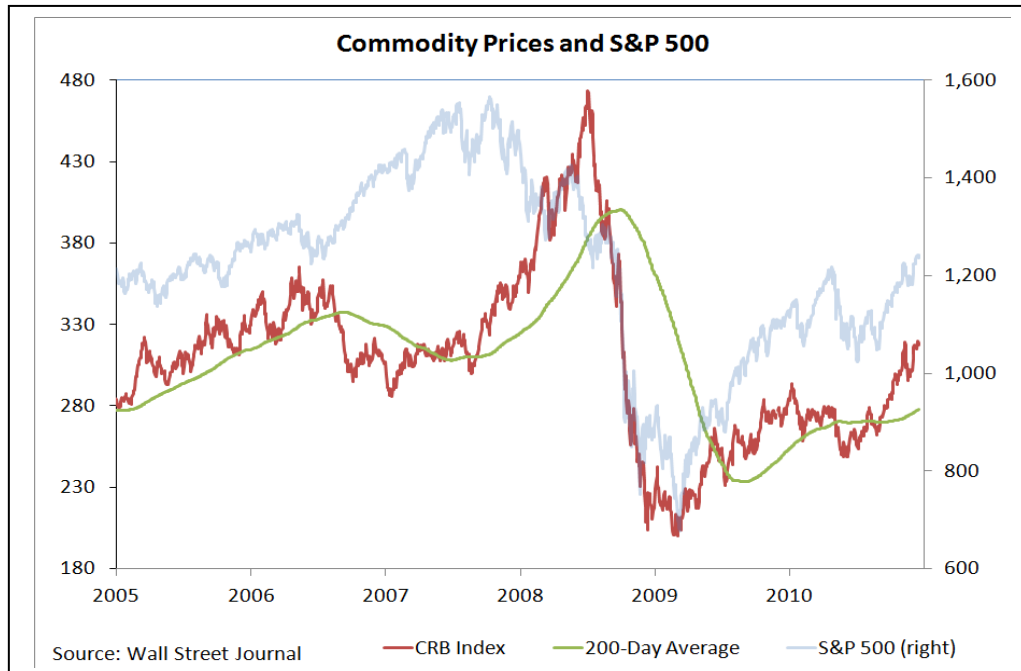
announced its intention to further expand its balance sheet, purchasing up to \$600 billion of Treasury securities by mid-2011. The goal of this effort is to lower longer-term interest rates, stimulating housing market demand through lower mortgage rates as well as commercial lending. As mentioned above, the short-term response by the bond market has been to push yields higher as the Fed has begun buy Treasuries.

**Ben Bernanke and company did not enter into this second round of quantitative easing lightly, and the domestic and international criticism that they have received is unlikely to deter them.** Nor

will a month or two of data showing better-than-expected growth. The Fed's efforts will receive a boost from the tax compromise that has worked its way through Congress. The Fed has maintained that it would prefer to have monetary policy working with fiscal policy to address economic headwinds. Substantial fiscal policy support seemed unlikely in current environment, as the chance for that was dashed by the seeming ineffectiveness of the first stimulus package. **The combination of tax cuts/credits and jobless benefits could provide a meaningful boost to the economy and will complement the Fed's efforts.**

Critics of the Fed's policy argue that these efforts will fuel inflationary pressures and the Fed will be unable to respond aggressively. The Fed, however, has already begun contemplating its exit strategy, which will likely include reverse repo agreements with banks and the ability to pay interest on reserves held at the Fed. Both of these tactics should allow the Fed to extract excess liquidity from the market without necessarily having to totally unwind its balance sheet. *These actions are not likely to be needed in 2011.*

It is uncertain whether these actions of the Fed's will fuel growth. **The fiscal stimulus provided by the tax compromise helps, but ultimately it will be the structural deleveraging of extended balance sheets that will build the foundation for economic growth.** *The Fed's efforts likely aid in this period of transition rather than represent an end-game.* Either way, the liquidity that is again flowing will likely have a positive effect on the stock and commodity markets. All



else being equal, we do not want to be in a position of fighting the Fed, and the Fed is aggressively attempting to prevent the deflation of the financial system.

### Valuations

We continue to view valuations as being neutral. Based on reported, trailing earnings for the average company in the S&P 500, stocks are neither cheap nor dear. That is our single-most preferred valuation indicator, but the overall message from the other valuation/earnings indicators is consistent with a neutral view toward valuations. Earnings growth over the past year has been strong, but this has mostly just satisfied elevated earnings expectations, which remain at a level that leaves little room for upside surprise. Earnings expectations have moderated somewhat in recent months, but remain at a level that has historically proved difficult for stocks to rally. This is in sharp contrast to March 2009, when earnings expectations were being slashed across the board and stocks were bottoming. Real earnings yields are relatively high, which is bullish for stocks, but much of the gain in earnings appears to have come from improved operational efficiencies, not top-line expansion. Profit margins are at record levels and substantial further improvement seems unlikely.

*We do not generally rely on valuations for timing decisions, but they are useful in evaluating secular risks.* As Keynes opined after all, "markets can remain irrational longer than you can remain solvent." **The valuation indicators do not point to a secular low having been made in stocks.** The dividend yield, while

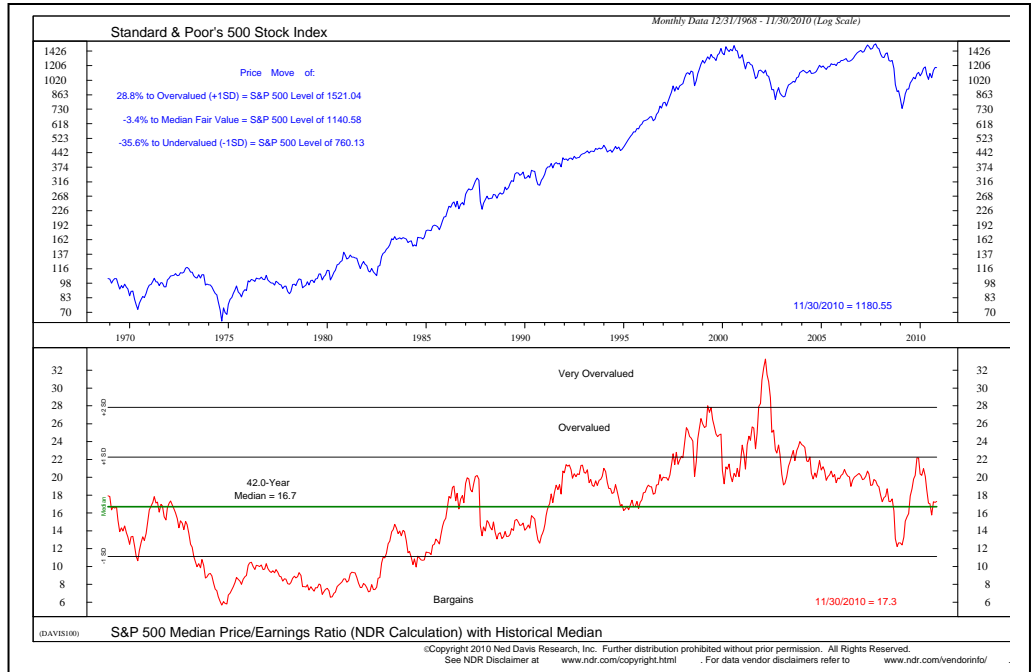
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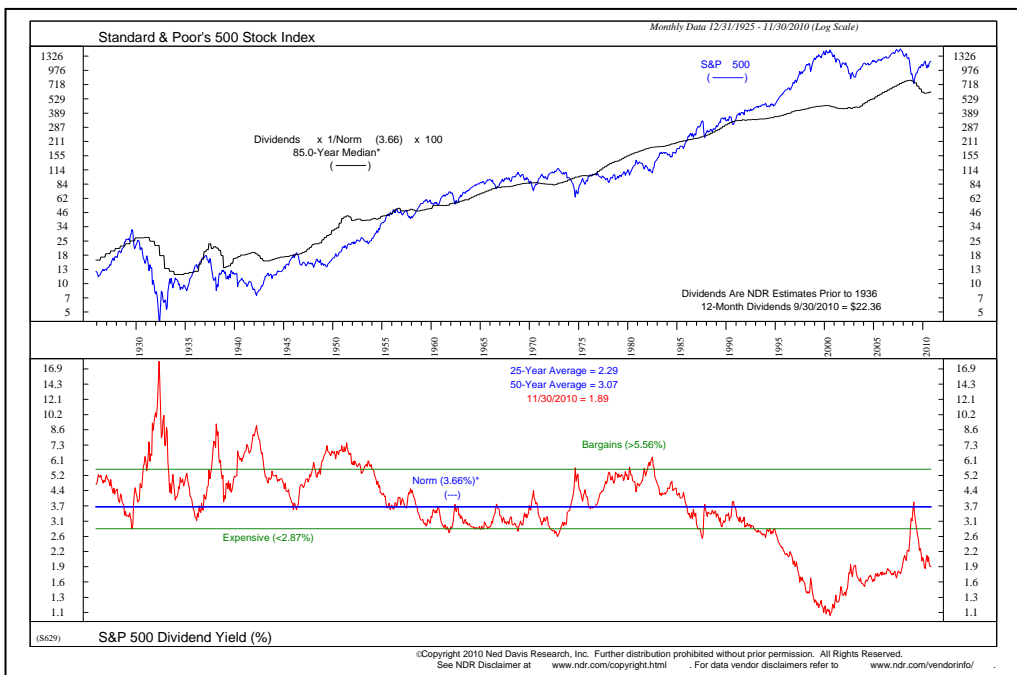
having risen in recent years, is below the levels typically seen at secular lows. Further, secular periods can be defined in terms of trends in price/earnings (P/E) ratios. The ongoing secular bear market has been characterized by a downward trend in P/E ratios and downward pressure remains intact. The P/E ratio we mention above has typically made it into single digits as stocks made secular bottoms. *This does not necessarily mean that a full re-test of the March 2009 price lows will be necessary.* Continued earnings growth would mean that a secular low P/E ratio could come at a price level above those seen nearly two years ago.

## Investor Sentiment

Investor asset flow data for mutual funds and ETF's, reported by Morningstar and aggregated by Baird, shows investors in 2010 continued the trends that emerged in 2009. *Investors intensified their move out of domestic equities and money market funds.* Following



the "flash crash" in May, the Investment Company Institute reported 23 consecutive weeks of outflows from equity mutual funds. *Investors intensified their move into international equities, while flows into bond funds appear to have moderated.* Data from the Federal Reserve shows the aggregate household portfolio, through the third quarter of 2010, with its highest exposure to equities since June 2008, with corresponding declines in bond and cash allocations. The primary differences between the Morningstar and Fed data are that the



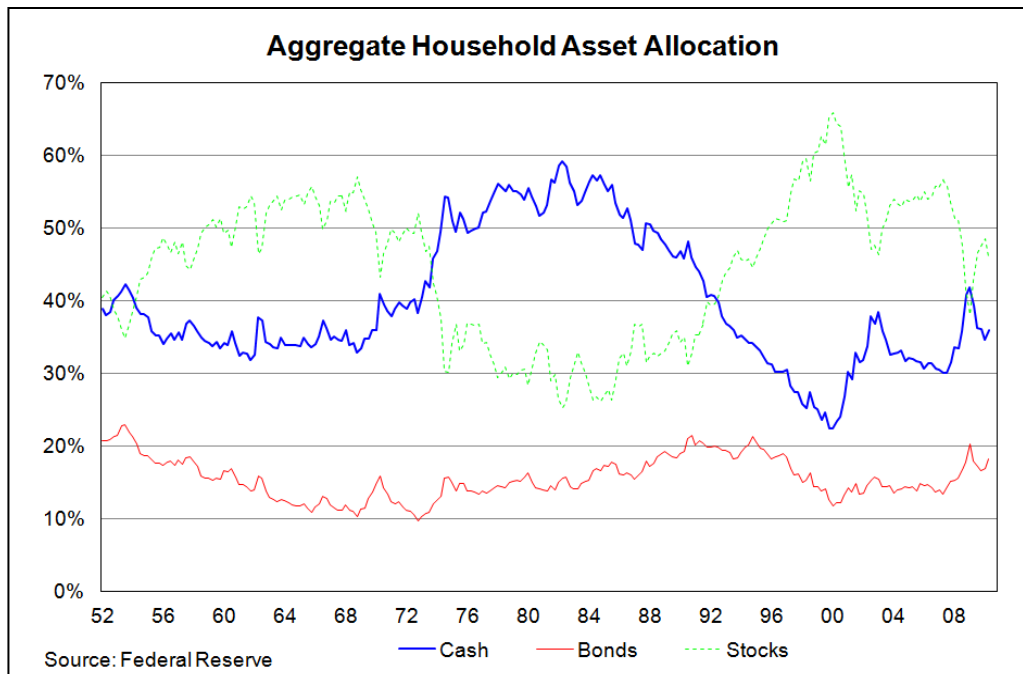
Morningstar data are fund flows, while the Fed data is more inclusive and it measures levels. **Despite the recent increase in exposure to equities, the trend away from equities and toward bonds and cash, is intact and is echoed by the flow data.** At the last secular bottom (in 1982), investors only had 25% exposure to equities – currently they are at 50% - further evidence that stocks have yet to hit a secular low. While flows have moved away from equities, mutual fund managers have remained fully invested as mutual fund liquidity ratios have remained low. This adds to volatility in the market, as weakness and redemptions

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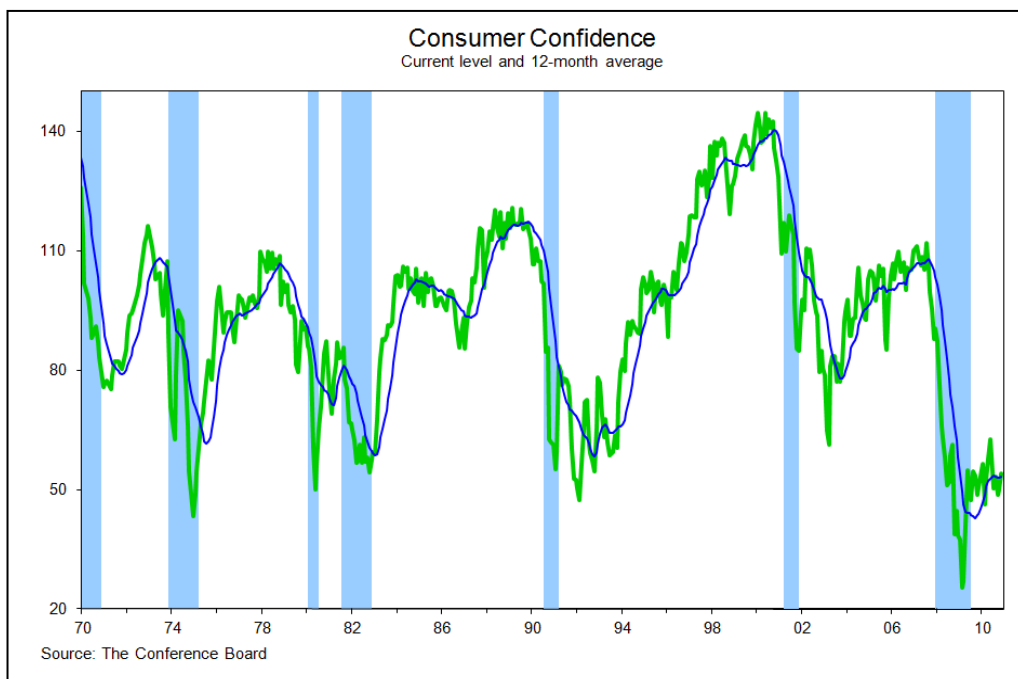
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have to be met with further selling from managers. It also reduces the pool of available buyers on down days (managers have no cash to deploy), exacerbating losses.

The investor/consumer surveys offer a mixed picture moving into the New Year. Both the Investors Intelligence and AAI sentiment surveys have shown elevated levels of bulls (better than 50%) and low levels of bears (approaching 20%). From a short-term perspective, readings above 60% bulls and below 20% bears (bulls-to-bears by a 3-to-1 margin) would suggest that the elevated optimism that is common around year end has gotten excessive. More likely, though, if near-term optimism is going to be a problem it won't be until the first part of 2011. **Even then, there appears to be deep-seated concern about the economy and the markets that could prevent optimism from staying excessive for long (the corollary is that if surveys do show excessive optimism for a protracted period, it may be time to tilt away from equities).** This can be seen in the



approval polls of various politicians and institutions in Washington DC and the results of the mid-term elections this past November, as well as measures of consumer confidence. Looking at the Conference Board's Consumer Confidence Index illustrates this point. *Confidence has rallied off of the extreme lows recorded over the past two years, but it remains at the extreme low end of the range going back nearly 50 years.* This pessimism provides some measure of support to the stock market and acts to balance the optimism that crops up in the weekly sentiment surveys.



### Seasonal Patterns/Cyclical Trends

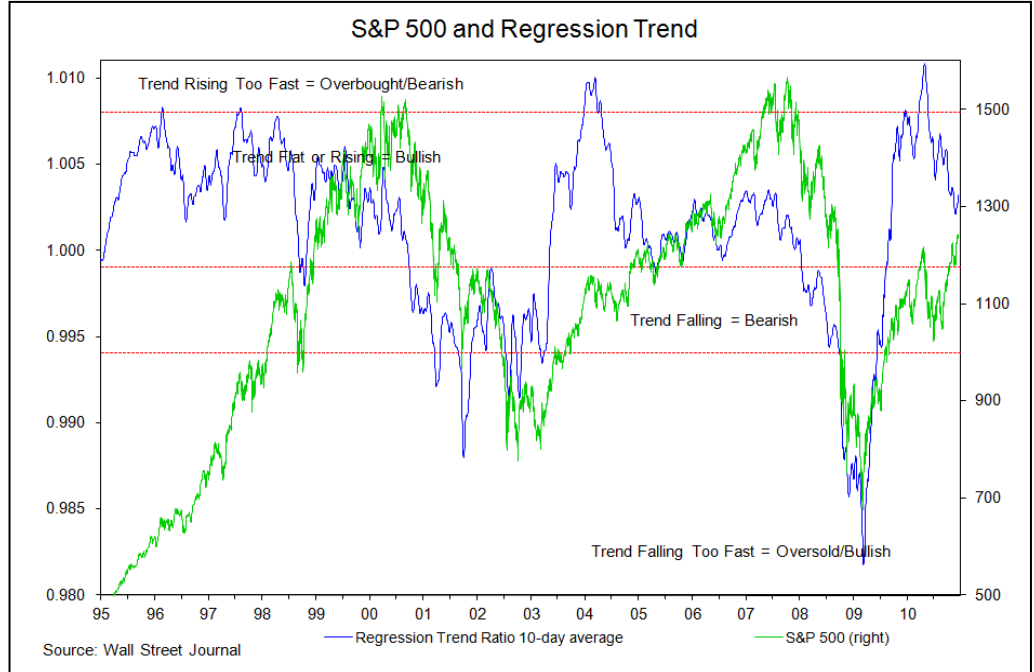
Our trend indicators suggest that the upswing that emerged in March 2009 remains largely intact and seasonal tendencies argue for higher prices into the middle of 2011. **Our most stable trend indicators continued to rise over the course of 2010, and while the pace of ascent has slowed, we have little evidence to suggest that a roll-over is imminent.** Some historically reliable indicators, namely the cross of the 50-

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day average below the 200-day average (the “death” cross), provided a false signal this summer that the trend had turned. This may have been due to the widespread attention it was paid. Many column inches were devoted to discussions of the “death” crosses that were emerging in various indexes and the ominous sounding “Hindenburg Omen.” *It speaks to the latent pessimism discussed above, that while these “signals” were widely followed and discussed, relatively little attention was paid to the “golden” crosses (the 50-day crossing back above the 200-day) that soon followed.* As we move into 2011, all 30 of the primary and secondary domestic indexes that we track have their 50-day averages above their 200-day averages – a strong signal that the cyclical trend is intact.

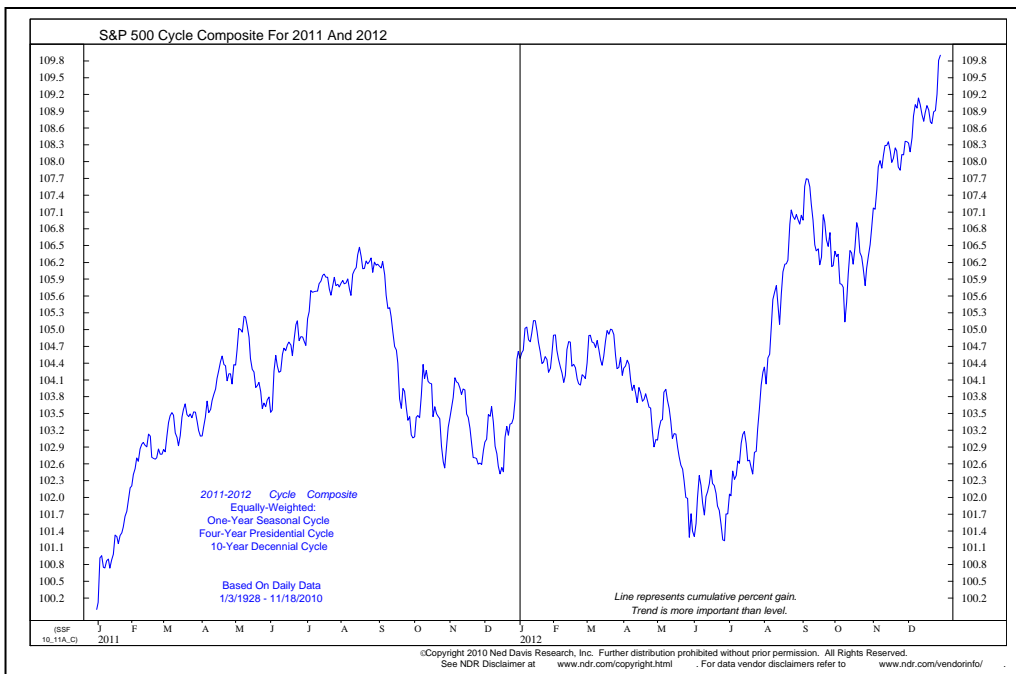
The prospects for a continuation of this rally into the middle of 2011 remain favorable based on the seasonal patterns. *Stocks typically fare well in the wake of mid-term elections, with strength persisting well into the third year (2011) of the presidential cycle.* Several mitigating



factors (change in control of Congress, the persistence of a secular bear market, the aging of the cyclical bull market) may reduce upside potential, but do not argue for weakness. The composite cycle chart for 2011 (which combines the presidential cycle with the one year cycle and the decennial cycle) suggests that stocks could begin to face rising headwinds late in the second quarter or early in the third quarter. While we do not map out our investment strategy around this single indicator, it is nonetheless a useful guide for evaluating risks and looking at potential paths for the equity market.

## Breadth

The cyclical rally in the indexes continues to enjoy strong support from the broad market. **The percentage of domestic industry groups in up-trends has climbed back toward 90% and the advance/decline line for the S&P 1500 has climbed back above its early-year peak.** We have moved away from relying on exchange-based advance/decline lines, as these can be unduly influenced by non-operating company issues that trade there, and prefer instead to

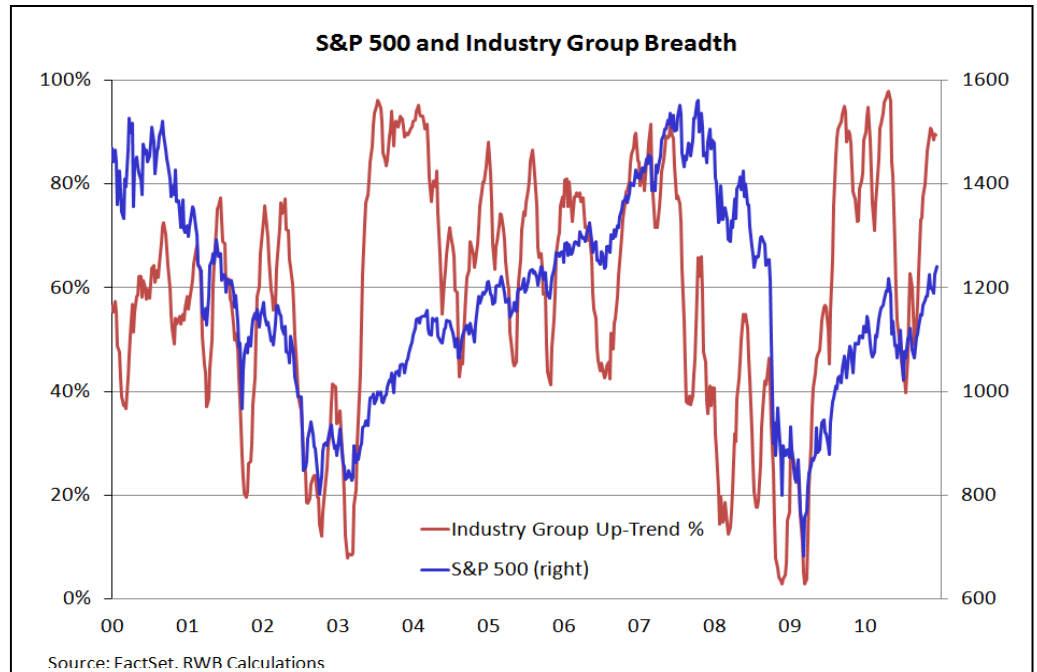


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look at index-based advance/decline lines. We have not found this adjustment necessary for all of our breadth indicators. We continue to look at the trend in net new highs being made on the NYSE and NASDAQ. This is expanding and has moved to a local peak, although it remains below the high seen early in 2010 – a failure to surpass that level may represent an early divergence between the indexes and the underlying market. We are also looking at other short-term breadth indicators (e.g., McClellan Oscillators and Summation Indexes) for signs of divergences. *Breadth indicators typically peak well before the indexes (the final stages of index rallies are typified by narrowing participation), and so recognized divergences are useful early warning systems.* We have yet to see any that raise significant concerns.

Another way to measure breadth is to look at trends in the ratio between small-caps and large-caps. This ratio has recently broken out in favor of small-caps, suggesting that the cyclical rally yet has life. This is also seen in our relative strength work done at the industry-



group level, which shows leadership by small- and mid-cap industry groups and lagging performance by large-cap groups. **The bottom line on breadth is that participation in the rally remains strong, although we will be watching for divergences that could start the clock ticking for the indexes in 2011.**

### Portfolio Implications

Having discussed the secular headwinds and cyclical cross-currents, it is time to focus on the true goal of this all. The needle we are trying to thread is the construction of investment portfolios. The specifics of each investor's financial situation and goals will vary, but the implications of the current investing climate and appropriate strategic approach has broad application.

Before discussing portfolio construction, let's consider return expectations. The nominal returns, be it capital appreciation from equities or yields from bonds, we see quoted are, in reality compromised of two parts: an inflation component and a real

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return. In a low inflation environment, the nominal return is more completely a real return. **Investors need to retrain themselves in this regard - nominal returns that are lower than the historical average may still be delivering the same real return as seen in the past.** Inflation right now is running about 1%, meaning a nominal yield of 4% provides the same real return as a nominal yield of 7% when inflation is 4% (which we saw as recently as four years ago).

In a low inflation/low return environment, investors should avoid the instinctive response of reaching for yield. **All other things equal, a higher yield implies greater risk.** And as we have learned in recent years, risks should not be overlooked during the portfolio construction process. *It may be more prudent to look at the expense side of one's budget and look for opportunities to cut costs rather than take on excessive risk in an effort to preserve nominal income.*

**Investors need to move beyond the old paradigm of a strictly buy-and-hold approach to the market and think about a more dynamic and flexible portfolio construction.** This includes looking across asset classes and investment horizons to prudently manage risks and find opportunities. Investors need to adapt to incoming data and changing conditions. While we may view as admirable efforts to "stay the course," this approach tends to close minds. When a mind is closed, learning (and often progress) stops. *This is not a matter of lacking discipline, but re-directing discipline toward risk management.* Market conditions change over time, and successful investors have found ways to adapt while not losing focus.

**Most investors would be well served by finding a means to implement a tactical investment approach as a significant portion of their overall portfolio.** To be sure, we are not advocating a strict market timing or intensive trading approach to stocks and bonds. That would be inappropriate for most investors (and in many cases a losing proposition). This type of approach allows for the evaluation of relative risks and the tilting of capital toward the most attractive areas (from a reward, as well as risk perspective). In our experience this often begins with expanding the question of stocks versus bonds, to stocks versus bonds versus cash (again considering both risk and reward). **In our view, a tactical approach is not an overlay but an integral part of an investment portfolio.**

Nor should a tactical approach be viewed as more risky than a strategic approach. While it moves beyond the investing paradigm that has been in place for sometime, a well executed tactical approach to investing allows for increased exposure to equities when conditions are more favorable while reducing exposure when risks are elevated. **In this regard, one may find lower volatility over time from a tactical portfolio than from a strategic portfolio that is designed under the old paradigm and implemented without regard to current market conditions.** The volatile market swings of the last several years have raised investor awareness of the need/desire to become more tactical. Since the market peaked in 2000, investors with a strict buy-and-hold strategy have realized virtually no capital appreciation in equities. More tactically minded investors/managers could likely have found ways to reduce equity exposure during the three cyclical bear markets (average decline of nearly 40% on the Dow Industrials) that have emerged during that time, while increasing exposure during the three cyclical bull markets (average gain of more than 60%) within that same time period. Tactical approaches further refine equity exposure (into size, style, and sector tilts) offered even more opportunity.

The evolution of the investing marketplace allows for more discrete exposure that could be easily gained in the past. The stock market is not homogenous and does not need to be approached that way. Exchange-traded funds (ETF's) are not an investing panacea, but they have allowed investors to efficiently gains exposure to (and avoid to exposure to) specific sectors and industries, to say nothing of asset classes, geographic regions and various commodities. These tools are not without risk, but are changing the way portfolios can be constructed.

**So then what are some keys to portfolio strategy as we move forward into 2011 and beyond:**

- Realize that expected return and expected risk in general are positively correlated.
- Be aware of risk and manage it aggressively.
- Stay flexible.
- Utilize a tactical investment approach to adapt to changing market conditions and risk levels.

## **Appendix – Important Disclosures and Analyst Certification**

### **Disclaimers**

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