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Quarterly Economic Update

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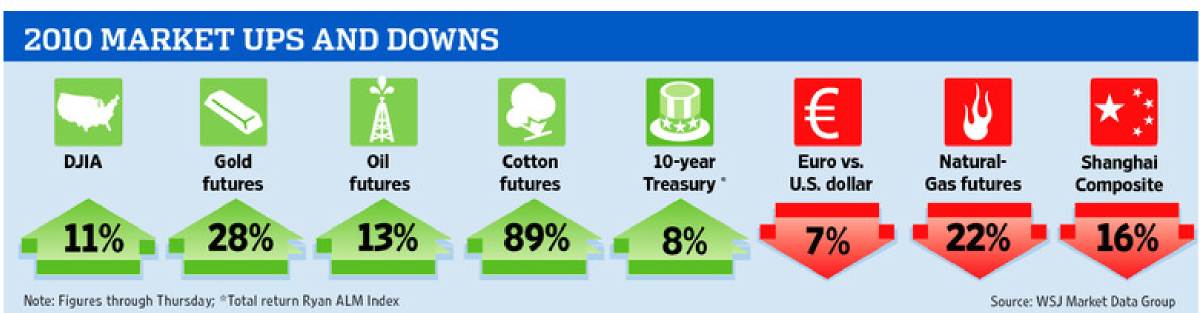
Amid stumbles and scares, the U.S. stock market finally ended with a second straight year of gains, in which the Dow reached levels not seen since the fall of Lehman Brothers in September 2008. But the final numbers mask what was at times another gut-wrenching year for many investors.

Stocks turned in another good year (see chart below), with the Dow Jones Industrial Average earning 11.1% for the year ending December 31, 2010 and a total return of 7.3% for the quarter ending December 31, 2010. The Standard and Poor's 500 Index also came in with solid earnings with a rate of return of 15.1% for the year and 10.8% for the quarter. NASDAQ did even better, earning 16.9% for the year and 12.0% for the quarter as of December 31, 2010. The second half of the year was responsible for almost all of the 2010 stock gains. Since hitting a low on July 2nd, the Dow has advanced 19.4%. *(Source: WSJ, Bumpy Ride for Stocks, December 31, 2010)*



Going into 2010, many investors had various reasons to be skeptical. Significant losses from the financial crisis were still fresh, and after 2009's 23.5% gain for the S&P, it appeared to many investors that the majority of gains might be over. In the spring of last year, most markets fell due to the European debt crisis, talks about the tightening of Chinese monetary policy, and the weak U.S. economic data.

Then a technical problem happened in the afternoon of May 6th that sent U.S. markets down significantly. In fact, at its afternoon low, the Dow dropped almost 1000 points (its biggest intra-day point drop ever) before quickly reversing course and recovering most of the loss before the end of the day. This "flash crash" rattled confidence and turned a harsh spotlight on the growing influence of high frequency traders and complicated types of investing.

Many stock investors decided to sell and began to move to the relative safety of U.S. Treasuries, pushing bond prices up and their yields down. Many investors wondered if the bond market was starting to price in the possibility of deflation. But that was a risk the Federal Reserve wasn't willing to take. On August 27th, Fed Chairman Ben Bernanke mentioned in a speech that the Fed would launch a second round of the bond-buying known as “Quantitative Easing” (QE2) to help bring down interest rates.

Bull Market for 2011?

The debate still rages as to whether stocks are overpriced or underpriced given the tense economic climate of the past two years and the uncertainties that lie ahead. Doubters point to low growth, high unemployment, and potential inflation, while believers focus on strong corporate profits and a supportive low-interest Federal Reserve.

There are a number of major indicators that support the argument that a Bull Market appears to be more likely on the horizon than a Bear Market.

1. The economy grew slightly faster than the government previously estimated in the 3rd quarter, and forecasters have been raising growth projections for the 4th quarter and for 2011. The Federal Reserve forecasts U.S. growth to be in the 3 - 3.6% range in 2011. *(Source: Financial Planning Magazine, January 2011, Outlook 2011)*

2. The nation’s Gross Domestic Product (GDP) rose 2.6% in the 3rd quarter, which followed a 1.7% growth in the second quarter, according to the Commerce Department. Based on these numbers, many economists believe that U.S. growth will continue. For example, Goldman Sachs raised its 2011 U.S. economic forecast from 2.5% to 3.4%.

3. The American stock market enters 2011 in an upbeat mood. In the past 4 months, it has increased by 20%. This partly reflects growth elsewhere: American companies make a third of the profits *outside* of the United States. *(Source: The Economist, January 1, 2011, Proceed with Caution)*

4. There was hopeful economic news at the end of 2010 as initial claims for unemployment fell to the lowest level in over two years. In addition to this, an index of pending home sales rose 3.5% for November. *(Source: WSJ, Bumpy Climb for Stocks, December 31, 2010)*

5. The decision to continue the Bush tax cuts is already producing something the U.S. economy needs: optimism. The tax deal, signed into law in December, has suddenly made many economists and consumers more confident about 2011. “That deal was measurably better than I had anticipated,” said Mark Zandi, chief economist for Moody’s Analytics. “I feel sentiment shifting. It feels like businesses are ready to turn the light switch on.” (*Source: Bloomberg Business Week, Suddenly the U.S., January 3-9, 2011)* This new-found optimism is even more striking when compared with the rest of the world. Europe appears to be stuck in its sovereign-debt problems, while China, India and many other emerging countries struggle to keep inflation from getting out of control.

6. This optimism saw holiday sales up more than 5.5% from last year, according to MasterCard Advisors’ Spending Pulse Report. They are now at an all-time high, nearly $10 billion more than before the recession. *(Source: Time Magazine, Holiday Spending Sprees, January 10, 2011)*

A key factor in trying to estimate what the market will do in 2011 is whether corporate profits can resume their high growth mode or whether they will continue to weaken as they have done for the past 2 quarters. The recently passed tax bill should add to corporate profitability, but whether it is enough to push gains toward the double-digit range is still an open question. Although many economists believe that it appears that the U.S. economy will have stronger growth in the first half of 2011, it is too soon to tell if this will be sustainable.

In the U.S., sustaining the economic momentum is the priority for now, even at the risk of causing inflation. *(Source: Bloomberg Business Week, Suddenly the U.S., January 3-9, 2011)* It is not yet clear if the effects of the new stimulus will be enough to generate sustainable economic activity. This is the main reason that the Federal Reserve has announced its second round of so called Quantitative Easing (QE2) with a plan to buy $600 billion of long-term Treasury Securities through June of 2011. QE2 is designed to make credit more available, help our economic recovery, and try to keep interest rates low. *(Source: Financial Planning Magazine, January 2011, Outlook 2011)*

Thus far, the Fed's plan has had unintended consequences for the bond market—interest rates went up and bond prices fell significantly during the 4^{th} quarter. The Fed's somewhat controversial actions show that it is willing and able to implement programs designed to spur the economy. However, the Fed has stated that monetary policy alone may not be sufficient to improve the pace of the economic recovery.

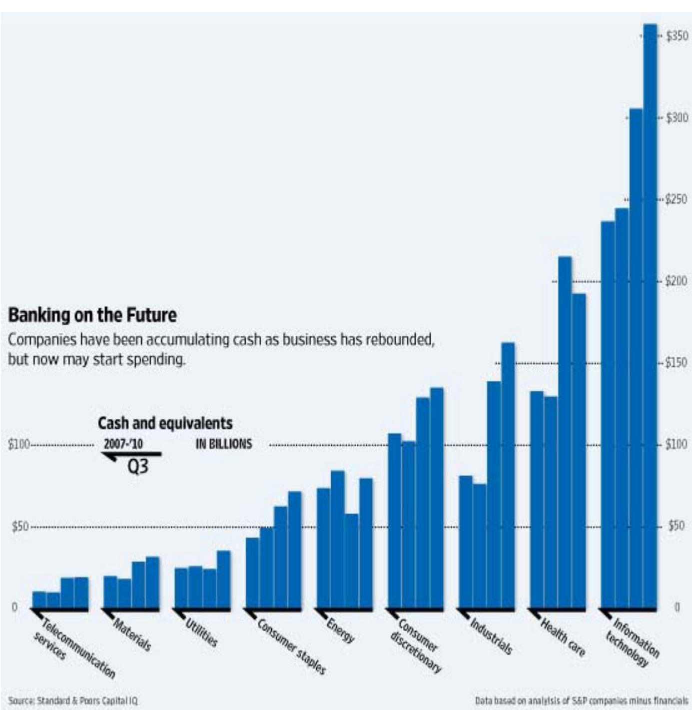
Some investors have expressed concerns about how QE2 might result in the depreciation of the U.S. dollar and lead to higher inflation down the road. However, if the economy doesn't add much steam, or has significant increases in exports, or increased spending by business or government, there is also the possibility that the Federal Reserve might once again pump money into the economy: "QE2" could be followed by "QE3."

Corporate profit growth has been strong since early 2009. Profit margins overall are at or near historic levels. Higher productivity is a key cause of these high margins. Businesses have learned to produce more with fewer workers and productivity has increased without having to add to payrolls. Many companies were able to increase profit margins even as costs of commodities increased. As economic growth continues, businesses will probably have to increase their payrolls. Another major advantage of the current economy is rock-bottom interest rates, which heighten the relative appeal of stocks.

Another factor on the "Bull" side is the market's price-earnings or P/E ratio at 13 times projected 2011 earnings, which illustrates that stocks do not appear to be excessively valued, especially relative to bonds and cash. That means the strong gains in share prices were due to higher corporate earnings, not any "irrational exuberance" on the part of investors.

The U.S. consumer will likely be a major wildcard in 2011. Despite high unemployment, lingering global economic turmoil, and endless bickering on Capitol Hill, many U.S. consumers appear ready to shoulder the hefty 70% share of the economy they typically bear. It has been very clear, according to JPMorgan's Michael Cemblaest's words, "The world's largest economic force – the U.S. consumer – is coming to life." *(Source: Nick Murray, January 2011, page 5)*

Until recently, a chronic lack of lending to businesses was seen by economists as one of the obstacles to a healthy recovery. Some big U.S. banks are starting to increase their lending to businesses as demand for loans rises and healthier banks seek to grab customers from weaker rivals. After declining steadily for the past two years, the amount of commercial industrial loans held by commercial banks increased during the last two months, according to the Federal Reserve. *(Source: WSJ, Banks Open Loan Spigot, December 30, 2010)*



An uptick in business lending is an optimistic sign for the economy and can help to make the recovery self-sustained. Such loans likely will be used by businesses to expand their operations, which could lead to new jobs and eventually to increased borrowing and spending by hired workers.

Another major case for being bullish: President Barack Obama has many reasons to repair relations with corporate America, but the most important one is that unemployment remains stubbornly high. U.S. non-financial businesses are sitting on nearly $2 trillion in cash and liquid assets—the most since WWII—and President Obama wants them to use it to create more U.S. jobs. After all, having all that money sitting around isn't doing much to help the economy recover, and it isn't helping the businesses much either, since it's earning about 0%. *(Source: Nick Murray, January 2011)*

Most of this money has accumulated over the last couple of years due to increased profitability. Where will this cash go?

Many corporations are looking to expand. With the new confidence in the global economy, some companies are focusing on the faster-growing economies of Asia, Latin America and Africa, rather than the sluggish markets of Europe and the U.S. Other companies plan to enlarge existing operations with new equipment, products, factories and research labs. Cash will likely go into investments, new plants and equipment, hiring, increased dividends, mergers and acquisitions, and share repurchases. Each of these is very positive for the economy, earnings, and ultimately stock share values. Please see the chart on the previous page on how companies have been accumulating cash as the economy rebounds.

"The Administration took some positive steps recently, striking a bipartisan agreement to extend current tax rates, moving the ball forward on the U.S.-Korea free trade agreement, and reaching out to the business community," says Thomas J. Donohue, the president of the U.S. Chamber of Commerce. "We're not going to agree on everything, but there's a lot we can get done for the American people." *(Source: WSJ, "President Revs Up Campaign…" A6, January 7, 2011)*

The change in tone comes after more than a year when many business leaders complained about the relations with the White House. Unfortunately, President Obama and the business community still have substantial disagreements. Healthcare and financial market regulations still upset many groups and the oil industry and other related industries are unhappy with moves to limit offshore oil exploration. *(Source: WSJ, "President Revs Up Campaign…" A6, January 7, 2011)*

Bear Market for 2011?

Even with all of these positive arguments that the economy should improve for 2011, we all know that improvement is not guaranteed by any means. There are still major areas of concern that investors need to remember.

While the economy is nearing a peak it reached before the crisis, and the recent economic data were mostly positive surprises, the economy is far from healthy. The growth rate is below the long-term average, and job growth is not strong enough to keep pace with the natural growth of the labor force, much less reduce the number of people who are unemployed and underemployed. Some economists believe that wage growth is also likely to remain low, and perhaps even negative, because of the large number of people looking for jobs.

High unemployment, tripling federal, state and local budget deficits and debt problems in Europe have kept many investors on the sidelines. Two definite risks to consumer spending are (1) if strained state and local governments are forced to lay off more workers than previously expected, and (2) if energy prices continue to rise (the average price for a gallon of gas in January has topped $3 for the first time in two years).

Other major problems facing us today include:

1. Social Security funding – yearly surpluses may turn to deficits in a couple of years, raising concerns about higher taxes and/or lower benefits.

2. Medicare funding – already facing yearly deficits, the program will now have the added burden of an additional 10,000 people per day reaching age 65 and qualifying for benefits.

3. State and local pensions – many of these programs are vastly underfunded and will put increasing pressure on local budgets, which may result in higher taxes and reduced payouts.

4. Political stalemates – the lack of political compromise in Washington doesn't bode well for the future.

Another important area to remember is the subject of confidence. Any fresh shocks to confidence on any of these topics may prompt consumers to start saving more and spending less.

Unfortunately, many economists believe that much of the public is focused on the "fear factor" while ignoring fundamental signs of strength in the equity markets. Unfortunately, a daily diet of journalistic pessimism has made many Americans feel like we are experiencing a catastrophe. *(Source: Mike Harvey)*

Another risk is that contradictory signals from an expanding economy might keep volatility high. The great amount of liquidity available at this time could easily start a herd mentality where a significant amount of money moves in and out of a particular sector in the market, thus causing significant volatility. Even Federal Reserve Chairman Ben Bernanke is concerned about an "unusually uncertain" environment again—he thinks inflation is too low and clearly wants to engineer higher price increases through this new monetary policy, QE2. Because this strategy has been untested, there is a risk that inflation might increase more than he would like. According Dean Junkens, Chief Investment Officer for Wells Fargo Private Bank, "We are trying to inflate our way to growth."

China

For almost 30 years, the Chinese economy has been the fastest growing major economy in the world. Since the early 1980s it has expanded at more than a 9% increase after inflation. China's economic performance is unprecedented—no country has ever grown so fast for such an extended period of time—and it is very likely that China will continue to grow rapidly for at least the next decade, if not longer. However, keep in mind that rapid economic growth does not always create generous investment returns. *(Source: WSJ, Why Investors Need China, December 14, 2010)*

2010 marked the first time that China's overseas investments were heavier in hard assets (like iron, oil and copper) than in U.S. Government bonds. In the first 6 months of 2010, China spent $31 billion on hard assets, compared with $23 billion on Treasuries and other U.S. Government bonds. Why? The most frequently cited reason is its need to feed its rapidly expanding industrial base.

China's net purchases of U.S. Treasury securities are likely to fall $55 billion in 2010 from about $100 billion in 2009, says Joe Quinlin, Chief Market Strategist at U.S. Quest. This preference for hard assets over Treasuries is sure to put upward pressure on U.S. interest rates and make U.S. economic growth somewhat more difficult than it would if China went back to its previous policy. China must maintain a balance between investing wisely and making sure the U.S. remains economically healthy enough to buy Chinese exports. Lately, however, any "China Effect" has been replaced by Treasury purchases by the Federal Reserve to its QE2 program.

China is now the world's second-largest economy and the world's largest consumer of copper, tin, steel, coal, aluminum, iron, and oil. *(Source: Barron's, China's Sure Bet, November 8, 2010)* China is a political and economic power an investor cannot ignore. But neither, indeed, can China ignore the U.S. Although the U.S. has a smaller population—310 million vs. China's 1.3 billion—the purchasing power of Americans is many times that of the Chinese.

While the Western world was celebrating Christmas and the holidays, China increased its key one-year lending and deposit interest rates over the weekend by 25 basis points in a continuation of unwinding stimulus actions taken to battle the recession. This is the Chinese government's latest maneuver to contain rising inflation, which reached above 5% in November. Chinese leaders have to do a balancing act to keep growth within a targeted range. Growing too fast or too slowly could lead to civil unrest. With a country leaving recession far behind, and inflation reaching its highest point in two years, Chinese policy is currently tilting towards controlling inflation and moderating growth.

The tightening efforts have impacted Chinese stocks. In fact, the Shanghai Composite Index has declined to its lowest point since early November, before the first interest rate increase. Even so, we can't forget that China is still growing in the range of 8% per year, significantly better than any other economy in the world.

Asia's two biggest economies, China and Japan, finished 2010 in the red. The Shanghai Composite fell 14% and the Nikkei shed 3%. *(Source: WSJ, World Stocks Defied Year, January 3, 2011)*

International Equities

International equities had a wide variety of investment performance in 2011, especially when you compare the developed market international equities, which posted a twelve-month return of 3.3%, to the emerging markets, which managed to achieve very strong equity returns of 20.2%. Although a global growth recovery appeared to be gaining further traction, there were signs that this might have some problems in the near future. For example, several countries (e.g., China, India and Australia) took steps to temper inflationary pressures by reining in strong economic growth, while others, particularly in the European Union, grappled with massive government deficits and deteriorating economic growth prospects. *(Source: Marsico, International Equities)*

Note that most international markets managed to tack on impressive gains despite an anemic recovery and a host of unexpected crises. "Not only did the world not end, but we realized the world can stand some misfortune and still turn forward," said Jeffery Knight, head of Global Asset Allocation for Putnam Absolute Return Fund.

Gross Domestic Product

Source: U.S. Department of Commerce; BLS; *The Economist*

The accompanying chart shows the growth per capita in the United States from the Civil War to 2009 (the last year for which the figures are complete). *(Source: Nick Murray Interactive, January 2011)* As you can see, the calculation is adjusted for inflation and is in real 2009 dollars. This is one of the greatest accomplishments in the history of economics. And our GDP is nearly three times larger than that of China, which has four times our population. Please also note that our GDP is very close to that of Europe, which has 60% more people.

In 2009, the U.S. GDP was $14.1 trillion compared to the world's GDP of $57.8 trillion. (Remember that the U.S. has 4% of the world's population.) The next largest economy in the world is Japan, with a GDP of about $5 trillion, which is only about a third the size of the United States. The United States makes up 5% of the world's population, but generates 25% of the world's Gross Domestic Product. *(Source: BTN, November 8, 2010 - Census Bureau)*

Although China still grows, the United States will still produce more than Japan and China combined. Simply put, America produces more with fewer workers.

Job Growth

Job growth will continue to be a front-page issue going forward. Despite the best efforts of industry and government, unemployment has remained stubbornly high. It is anyone's guess on how long it will take to reabsorb the 7 million jobless workers we have now, and for unemployment to fall to about 6% of the workforce.

Private-sector employers picked up the pace of hiring significantly in December, and a report on January 5th indicated increasing optimism that the U.S. job market might be improving. Companies in the private sector added 297,000 jobs last month, according to payroll processor Automatic Data Processing Inc. and consulting firm Macroeconomic Advisors LLC. The gain was the largest in the report's 10-year history, and nearly tripled many economists' forecasts.
"The economy is clearly gaining momentum," said Zach Pandl, Nomura Securities International Inc. economist. "With that should come better jobs data." *(Source: WSJ, Private Sector Sees Hiring Surge, January 6, 2011)*

This report, along with recent declines in new claims for unemployment benefits, fueled optimism that economic growth is picking up. But a key question still remains: Will job creation finally pick up?

18 months after the recession officially ended, economic growth has been too slow to help the labor market much. The unemployment rate has been above 9% since May of 2009—the longest stretch above that threshold since the Great Depression. Employers have added only about a million jobs to their payrolls in the past year, a fraction of the 8.4 million jobs lost in the two years before that. The weak labor market is keeping much of the housing market in the dumps. Now, signs are pointing up across the economy offering hope for unemployed workers.

Housing

Most economists agree that a lasting general recovery is unlikely without a recovery in the housing market. Last week's Case-Shiller report showed that house values are still declining at a double-digit annual rate across the country. The best we can hope for is some degree of stability, without much increase in real value. The question is whether fresh declines may bring more buyers into the market. Ultimately, that would be good for housing, even if price declines prove painful.

The Obama Administration is expected by the end of January to put together a housing plan expected to deal with housing giants Fannie Mae and Freddy Mac. It is still unknown how much of a government backstop for mortgages the government may propose. *(Source: WSJ, Housing Market Facing Blizzard, December 29, 2010)*

The sudden jump in Treasury yields has driven 30-year mortgage rates above 5%, keeping pressure on the struggling housing market and countering the Federal Reserve's efforts to help the economy. Even with rates hovering at historically low levels, any rise is likely to weaken housing demand, putting more pressure on sellers to cut their asking prices. A general rule of thumb holds that every 1% increase in rates effectively raises home prices for buyers by roughly 10%.

Tax Law Changes

The uncertainty of the tax laws also caused significant headaches for many investors. The final decision regarding the tax rates was not made until the end of the year. Very few uncertainties appeared to be worse than the uncertainty of the tax rate changes. Since this is no longer an outstanding item, this is also another argument for a bullish 2011. *(Source: Nick Murray Interactive January 2011)*

The battle to extend the Bush-era tax cuts was politically divisive, and the process agonizingly prolonged. Yet the decision to continue the cuts, and throw in a few others, is producing something the U.S. economy needs: optimism.

The most important point to remember is that last year's 11th hour tax changes, though favorable for most, are temporary. After 2012, many provisions are set to go back to what they were before 2001 and a few even expire this year. That raises the dreary possibility that in less than two years we will have a replay of last year's tax debates, but in the middle of a presidential campaign. We will see how that pans out.

Meanwhile, here are some important changes for 2011:

- Income taxes. This year's low tax rates are carried over from last year and expire at the end of 2012.

- Tax rates on long-term capital gains and stock dividends. These tax rates will continue at historic lows—for taxpayers in the 15% income tax bracket and below, the rate is zero; for taxpayers in the 25% bracket and above, the maximum rate is 15%. This expires at the end of 2012.

- Estate and gift taxes. The top rate is now 35% and the exemption has been increased to $5 million for individual state and gift taxes. This also expires at the end of 2012.

- Payroll taxes. Last year's big surprise was a temporary 2-percentage point cut in the employee's share of Social Security tax, saving a maximum of $2,136 per worker.

There are many other changes that took place at the last minute. We will be issuing a more detailed report in the near future regarding all of these tax law changes and how they apply to you.

Bonds

Some financial advisors say bond investment may pose a bigger risk to investors in 2011 than stocks. That is because many investors are becoming more optimistic about the U.S. economy and economic growth can lead to inflation and higher interest rates, which are inversely related to bond prices. Long-term bonds tend to lose the most value during interest rate increases, so many advisors have been reducing their holdings in this area and instead buying bonds that have shorter-term maturities.

Normally investors put their money in bonds when they are very worried and often after they have taken such a beating in stocks. Eventually that concern subsides, only to be replaced by greed. That is when investors often spurn fixed income investments and start buying back stocks. Then, when another market cycle ends, they often get nervous again—and the fear-greed seesaw repeats itself.

At least, that is the way it usually works.

So what should the prudent investor do? Bonds are an essential part of a conservative portfolio: they provide income and are usually more stable than stocks. If you are retired and relying on investment income to pay the bills, in most cases, it's not appropriate to invest only in equities. Unfortunately, the Federal Reserve's strategy of keeping short-term rates near zero has made it impossible to earn very much on your cash.

Ever since the global financial panic struck, many investors have been piling into Treasury bonds for a simple reason: there is virtually a zero risk that the U.S. government will default. Yet Treasury bonds aren't nearly as secure as many investors might think. You cannot ignore the risks in today's bond market. Some investors believe that we are in the middle of an inflating bond bubble that is soon to pop.

The municipal bond market was battered as Treasury yields rose, uncertainty about government policy grew, and worry about the fiscal position of many state and local governments became more pronounced.

The mentality of today's bond investor has drastically changed. The traditional view of investing in bonds for yield income has been replaced by investing in bonds for capital preservation. Meanwhile, little thought has been given to interest rate risk and issuer credit risk. "I don't think investors fully appreciate the equity-like volatility we've seen in this market," says Joseph Davis, chief economist at Vanguard.

Let's take a look at long-term bonds. Their returns have beaten those of shorter-term issues, but take a look at 30-year Treasuries. Since 1980, their yields have dropped from 15.2% to 4.4%. It is difficult to imagine the yields dropping significantly further. If interest rates increase to 5%, a 30-year Treasury could sink 9%. That is a lot of risk with what is supposed to be your "safe stash." This year many experts say they believe that interest rates will rise because they see clear signs that the economy is finally getting up off of the floor. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

Treasuries of all maturities lost nearly 3% in total return during the 4th quarter, according to Barclays Capital Indexes. The dramatic 4th quarter increase in yields was primarily responsible for the drop in value. The driving force behind rising yields is a matter of debate. Higher bond yields can result from stronger economic growth expectations, fiscal worries or higher inflation.

As mentioned previously in this report, one of the goals of QE2 is to hold down mortgage rates to aid a housing recovery and keep credit cheap for consumers and companies to spur the weak economy and boost employment. The problem is that neither the public's infatuation with bonds nor the Fed's epic stimulus will last. It won't be long before investors will become dissatisfied with low yields. And once the economy rebounds, the Fed will need to stop buying long-term bonds and substantially raise the Fed Funds rate. That is the pattern in every recovery, and we believe it should happen again. (Before the credit crisis, the Fed Funds rate was at 4.25%. It is now 0.25%.)

If inflation starts to increase, the Fed may start to raise interest rates to keep inflation in check. When interest rates go up, bonds often go down in value. In fact, interest rates don't have to rise much for bond investors to realize substantial losses—even the *fear* of interest rates going up is usually enough for the value of bonds to go down.

While Treasury bonds are less volatile than stocks and have features that stocks don't, bonds are far riskier than some investors appreciate. Interest rates are at their lowest levels since the 1950s. Investors who grasp for that last percentage point of yield and buy long-term bonds are making a gigantic bet that rates will fall even further or at least hold even. However, with rates this low, the question really isn't if they will rise, but when. If inflation rears its ugly head and interest rates rise, depending on the bond, an investor may still receive their investment back if they hold their bonds until maturity, but not in real terms, of course.

Let's now talk about Munis. The municipal bond market is suffering one of its periodic selloffs. There have been many concerns recently regarding the fiscal plight of state and local governments, and some continue to argue that defaults on debt obligations will increase dramatically. Although this is a matter of debate, many economists believe that states and the vast majority of local governments will take the actions necessary to balance their budgets and ensure full and timely payments on their general obligation debt. While the Federal government continues to provide assistance to state governments, direct aid is declining. Without additional federal aid, states will have to balance their budgets by cutting spending and off-loading costs to local governments. *(Source: BlackRock, December 2010)*

Pension liabilities are major concerns for many state and local governments given their declining asset values and funding pressures. Union contracts and associated pension benefits may cause higher rates of local bankruptcy. Taxpayers face as much as $3 trillion in unfunded state workers' retirement liabilities, according to a study by the University of Rochester and Northwestern University. Soaring pension costs are igniting political fights nationwide. In fact, the cost of government pensions could become one of the defining policy issues of the coming decade. *(Source: BlackRock, December 2010)*

Ben Bernanke earlier this month ruled out a Central Bank bailout of state and local governments strapped with big municipal debt burdens, saying the Fed had limited legal authority to help and little will to use that authority. In fact, he said, "The states should not expect loans from the Fed."

Inflation vs. Deflation

Will it be inflation or deflation? Either could be damaging to businesses. Inflation allows rising costs to eat into the bottom line. In contrast, deflation causes consumers to cut back on purchases as they wait for prices to drop further, often leading to more layoffs, less demand and a spiral of sliding prices.

The United States has been running a budget deficit for the last 10 years. The government debt level increased significantly after the 2008-2009 financial crisis, and is expected to increase for the foreseeable future. Given these high deficit levels, many economists believe that inflation will soon be much higher, even though the current inflation level remains quite low. *(Source: Financial Planning Magazine, The Inflation Scenario, September 2010)* However, many economists believe that there is so much unused capacity in the United States there won't be significant inflation for at least a couple of years.

While inflation has remained low for some time, the recent rise in commodity and food prices suggests that it is possible that there might be an increase in the near future. If the U.S. dollar weakens and our trade balance remains the same, rising commodity prices might lead to a significant jump in inflation. Such an increase will most likely suppress consumer spending, which is already being held down by high unemployment. (Although, consumer expectations about inflation often drive their purchasing decisions, making rising or falling prices a self-fulfilling prophecy.)

U.S. inflation is extremely low—so low that the Federal Reserve wishes it were a bit higher. However, many people don't see it that way. Many consumers think that prices have been rising faster than the 1.2% the labor department has reported for the past year. For example, a mid-November survey found that participants' median forecast was 3.0%. People's perception of inflation often differs from reality, and their experiences can change depending on who they are and where they live. *(Source: WSJ, Public Still Feels Inflation, November 29, 2010)*

Why the difference between the government's computation and the consumer's estimate? Rising food and energy prices may be one reason. Changes in the price in of food and energy are felt the keenest by the consumer, but are not included in the calculation of the inflation rate! *(Source: WSJ, U.S. Inflation Flat, November 18, 2010)*

Inflation is spreading across the world's largest emerging nations. A better-than-expected economic recovery in the U.S. could fuel inflation by sending a jolt of demand to the global supply chain, causing economies already running at full capacity to overheat, many economists say.

Unfortunately, demand is strong and many investors eager, which in turn caused the commodity markets to increase significantly in 2010. This could certainly be a bubble ready to burst at any time.

Many agricultural commodities saw unusually extreme price swings. Some commodities hit new highs and then collapsed. Many food crops also increased significantly due to various reasons. For example, a drought in Russia sent wheat prices soaring and corn soon followed. By year end, corn prices were up 93% from June lows and ended the year up 51.8%. *(Source: WSJ, Commodities Rally Across Board, January 3, 2011)*

The U.S. Department of Agriculture cut its estimates for global harvest of key crops and raised its demand forecasts, which added to worries about rising food prices and evidence of tightening global food supplies. *(Source: WSJ, Prices Soar on Crop Woes, January 13, 2011)*

Some people, however, are concerned more about deflation. This is caused by supplies exceeding demand, as experienced by Japan over the past 2 decades. As countries like China and India build excess manufacturing and service capacity, they don't have the necessary level of internal demand, so it ends up being exported. And of course you no longer have a U.S. consumer buying like there is no tomorrow, which increases downward pressure on prices.

In addition, some investors are concerned that past governments have used inflation as a way of dealing with a heavy debt burden.

One of the ways to protect yourself against inflation risk is by investing in Treasury Inflation-Protected Securities (aka TIPS), whose principal increases when the Consumer Index does. The ROI on TIPS usually has a very low interest rate and the wildcard is inflation—merely an estimate! Who knows what inflation will be 5 years from now? Investors should be aware that the TIPS principal is adjusted downward for deflation, and interest payments may be less than they would be if inflation occurred and the Consumer Price Index remained the same.

Well, a very important event occurred at the end of October: The Treasury department conducted a sale of 5-year TIPS at the end of October and produced the first negative yield in the history of the U.S. debt! The securities drew a yield of negative 0.5%, which means that if you invested in TIPS, you also had to pay the Government for them to hold your money. The reason for this is that most of the investors in these TIPS predict that inflation will be here in the near future—that's the only reason they would put their money in this investment!

Gold

As we start 2011, gold continues its climb and many investors are questioning its future price direction. Is gold in a bubble? Have the price gains in the last decade (which beat out stocks, bonds, and many other asset classes) peaked? Did today's investors miss the opportunity to buy?

Since 2002, gold climbed from $275 an ounce to over $1,400 as of end of 2010. The excitement also extended to other precious metals, including silver, which was up 81% for the year. Unfortunately, most investors see gold as another dollar-based asset class to be evaluated using the same formulas as stocks and bonds. *(Source: OnWallStreet, January 2011, The New Gold Rush)*

Gold has traditionally been considered a hedge against high inflation. However, at this moment, Ben Bernanke indicates that high inflation will not rear its head up any time soon.

Gold is extremely volatile and the market swings can be greater than many investors can take. Many economists believe that a significant part of gold investing is emotion and not by any other computation of value.

There is a good likelihood that gold is in a bubble right now. Therefore, based on the old rule of thumb of "buy low, sell high," it might be best to wait on the sidelines for the price to drop a bit before an investor puts some serious money in gold. Speaking of that, due to the volatility and lack of liquidity, we do not recommend more than 1-3% of your total portfolio invested in gold or a similar precious metal, and then only if you can weather the storm and have the courage to hold on during times of turbulence. It's important to speak with us about your individual situation prior to considering making any changes to your portfolio.

Conclusion

As you have read throughout this report, there are major indicators that the economy is recovering, but many concerns remain. Although, in my opinion, things look better than worse—the glass is half full, not half empty—we know that the financial markets will give us some problems at some point in the future.

One thing that has changed in 2011 is control of Congress, which will be split between a Republican House and a Democratic Senate. This will most likely produce political gridlock in the Nation's capital. Although some observers think that gridlock will be good for stocks because Congress won't be able to enact laws that could harm business, it could be a negative if lawmakers are unable to address a financial emergency.

It appears that the current economy is missing 3 important engines that drove our economy in the good times in the recent past. They were:

1. A booming stock market
2. Surging home values
3. Rapidly growing personal debt (leverage)

Once you take these away, the best we can hope for is to cruise along without any real problems.

This puts even greater weight on making careful plans and working hard to carry them out. Most people will not be able to borrow their way out of financial difficulty, or get a "bailout" from capital gains or increased home equity. Most of us can still reach our financial goals, but it will take more work, more discipline and more time.

While the mood is much improved from only a year ago, many executives fear that the cost of energy, raw materials and other commodities will keep rising, and that high unemployment will continue to restrain consumer spending. While the credit crunch that helped lead to the recession has eased, some investors remain jittery about the threat of trade barriers and volatile currency exchange rates.

Profit growth for corporate America might slow in 2011 partly because some companies will be up against tougher year-early comparisons and partly because higher sales are prompting them to invest more in plants and equipment and in some cases, hire more workers.

The degree of both confidence and planned spending varies across industries. Companies with the greatest global reach, particularly in emerging nations, appear to be the most bullish, while those largely dependent on U.S. consumers appear to be the most reserved. *(Source: WSJ, January 3, 2011, Big Firms Poised)*

The conclusion today is similar to that we've had in the past – whatever you do, make sure that you are diversified into different areas so that no matter what the actual outcome of this economy ends up being, you will hopefully avoid a major drop in your portfolio. As always, we are here to answer any of your questions. We look forward to discussing your finances with you soon.

P.S. Boom, Baby Boom! A recent report from the PEW Research Center indicates that, beginning in 2011, about 10,000 people a day will reach 65, and that this rate will continue for the next 19 years.

P.S.P.S. We have been very fortunate in that many of our best clients have introduced us to some other high quality people who we have assisted and became clients. If you know someone that you feel can benefit from our services, please give us a call.

Sources: Wall Street Journal (10/25/10, 11/4/10, 11/13-14/10, 11/16/10, 11/20-21/10, 11/18/10, 11/29/10, 12/10/10, 12/14/10, 12/17/10, 12/23/10, 12/29/10, 12/30/10, 12/31/10, 1/3/11, 1/6/11, 1/7/11, 1/8-9/11, 1/10/11, 1/13/11), Barron's (11/8/10, 1/3/11), Money Magazine (Jan/Feb 2011), Bloomberg Business Week (10/18-24/10, 11/18-14/10, 1/3-9/11, 1/10-16/11), Kiplinger's Personal Finance (1/2011), By The Numbers (1/8/10), Fortune Magazine (12/27/10), Investment News (111/10, 11/15/10), The Economist (9/4/10, 10/30/10, 12/18/10, 1/1/11), Forbes (12/20/10), Nick Murray Interactive (January 2011), Financial Planning Magazine (September 2010, January 2011), Time Magazine (1/10/11),