Market Update

2010 Year in Review

Top 10 in 2010

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As New Years Day approached, the media inundated us with Top 10 lists of 2010: top 10 movies, top 10 songs, top 10 best dressed, and so on. So, as 2010 has moved into the rearview mirror and we look forward to 2011, what better way to say farewell to 2010 than to present USI Advisors, Inc.'s "Top 10 in 2010" highlighting the most notable economic and market-related stories of the past year. Also included is an outlook for what to expect in 2011.

#10 Coming off the "Lost Decade"

Some economists and market pundits have referred to the first decade of the new millennium as "The Lost Decade," pointing to the stagnation of the U.S. economy over the time period starting in 2000 and ending in 2009. Job growth was essentially non-existent, as modest job growth from 2003 – 2007 could not make up for the jobs lost during the two recessions. The financial sector almost collapsed completely; with long-time financial stalwarts Bear Stearns and Lehman Brothers (among many others) failing. Gross Domestic Product ("GDP"), which measures economic output of the United States, was weak and household net worth, adjusted for inflation, tumbled amidst plummeting home prices, less-than-stellar stock market returns and skyrocketing household debt. Not surprisingly, the stock market fared poorly. The S&P 500 Index fell an annualized 1.0% during the decade and the Dow Jones Industrial Average ("DJIA") gained a meager 1.3% annualized rate of return.

So, as we started a new decade in 2010, fears were rampant that the U.S. economy would slip into a double dip recession and markets would continue to struggle. However, 2010 turned out much better than expected. The economy showed signs of life and the markets rebounded nicely with the DJIA gaining 14.1% while the S&P 500 Index surged 15.1%. Unfortunately, the economy is not out of the woods by a long shot. Challenges remain, particularly in the job market and housing market. Only time will tell if the remaining nine years of the new decade can be as promising as the first.

#9 Reverse Seasonality

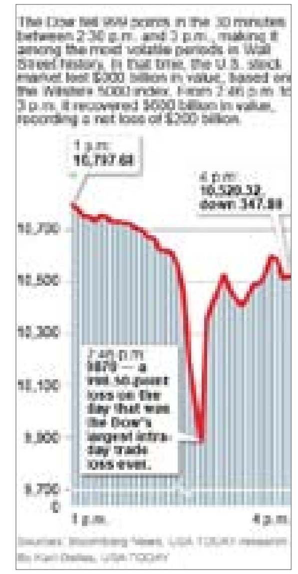
Every year, as summer comes to a close, the financial media outlets remind investors of the poor historical track record of the equity market during September and October. As a result, by the end of this past August, investors expected the equity market would sell off in September and October, as history has shown plenty of reasons why these two months have been so harsh:

- Four times in the past decade, the S&P 500 Index shed at least 5% in September and the average September return since 1926 is a decline of nearly 1%
- Two years ago, the credit bubble burst in September with the collapse of Lehman Brothers
- The 2000 – 2002 bear market found its low in September/October of 2002, with an interim bottom in September/October of 2001
- The 1998 crisis began in late August and lasted through the following two months
- The famous 1987 crash came in October
- In 1929, the crash occurred in October, following a market peak just after Labor Day and, to add to fears, the worst month of the depression was September 1931, when the DJIA fell roughly 30%

But, 2010 thankfully provided us with a bit of relief from the usual seasonality of the market. September was surprisingly strong, as the DJIA tacked on 7.9%, which was the best September return since 1939. The S&P 500 Index added even more, gaining 8.9%. Moreover, October was also a solid month with the DJIA and the S&P 500 Index adding 3.2% and 3.8%, respectively.

When this coming summer comes to a close, we will undoubtedly hear about the seasonality of the markets yet again. But, after experiencing such a strong September and October in 2010, it will be nice to know every once in a while the markets can buck the trend.

#8 The Flash Crash



On May 6, 2010, the DJIA plummeted 700 points in seven minutes, with an intraday loss of nearly 1,000 points, sending market participants into a panic. Investors watched as the markets experienced a free fall, reminding more seasoned investors of the October 1987 crash. Fortunately, however, by the end of the trading day, the markets recovered most of its decline, ending the day down "only" 347.8 points or -3.2%. Speculation on what caused this event was rampant – was it high-speed traders, a glitch in programming, or even financial terrorism?

Federal regulators began investigating immediately and on September 30th explained that a sell order for 75,000 E-mini futures contracts by a mutual fund, Ivy Asset Strategy run by Waddell & Reed Financial, helped trigger this sell-off. The SEC and the CFTC (Commodities Futures Trading Commission) issued a joint report citing that May 6th was initially an unusually turbulent day due to the Greek debt crisis and, that after the large sell order, high-frequency traders began quickly selling, accelerating the effect of the original large sell.

At one point during the day, nearly $1 trillion worth of market value was erased. An automatic stabilizer on the futures exchange cut in and paused trading for five seconds, after which the markets recovered. Since then, breakers have been put in place, which halt trading in a stock for five minutes if it moves 10% or more in a five minute period in an effort to prevent an event like this from reoccurring.

#7 Dominance of Emerging Markets

Emerging economies remained the drivers of global growth in 2010 and this was reflected in the market performance. After returning 70% in 2009, the MSCI EM Index returned 19.2% in 2010, topping both the MSCI EAFE Index's return of 8.2% and the 15.1% return of the S&P 500 Index.

China led the way with double digit GDP growth in the first half of the year. Third quarter growth for the far east country was slightly below 10%, which is still quite impressive. Concerns about inflation and the value of the Yuan, the Chinese currency, rose as China's exports skyrocketed. In May, exports grew 48.5% from the previous year; the biggest jump in six years. China reached a few milestones during 2010, surpassing Japan in late summer to become the second largest economy in the world and overtaking the United States as the largest consumer of energy.

China wasn't the only emerging market country with strong growth, India and Brazil grew substantially as well. India reported year-over-year rise in third quarter GDP of 8.9% and the Indian central bank raised interest rates to combat inflation (7.5% in November). Brazil's growth was not as high but was still strong; posting 6.7% year-over-year growth and newly-elected Brazilian president, Dilma Rousseff, the country's first female president, is hoping to spur more economic growth during 2011.

The rise of developing economies has not gone unnoticed as developing nations strive to have a stronger voice in world organizations such as the IMF and United Nations ("U.N."). The U.S. supported India having a permanent seat on the U.N. Security Council; currently comprised of China, France, Russia, the United Kingdom and the U.S.

Overall, the growth of the middle class in emerging economies and the low debt ratios compared to that of many developed countries (emerging markets represent almost half of global GDP but owe only 10.5% of global debt) continue to make emerging markets an interesting prospect heading into the New Year.

#6 Changes on Capitol Hill

Americans voiced their displeasure with the current state of the nation and on Election Day, in one of the biggest political party swings in decades, voted for change on Capitol Hill. Republicans won control of the House of Representatives, while Democrats retained control of the Senate. The change in political party will have an effect on how future legislation will be shaped and the election results indicate political gridlock is returning to Capitol Hill.

Changes have already been made and are likely to be beneficial for the economy and the markets. In December, Congress pushed through an extension of the Bush-era tax cuts and approved an $858 billion bill, with $801 billion in tax cuts and $57 billion for extended unemployment insurance. In addition, the U.S. signed a free-trade agreement with South Korea, the biggest trade deal since the North American Free Trade Agreement ("NAFTA") with Mexico and Canada.

The mid-term elections are likely to bring further changes that will impact the economy and the capital markets. The degree of cooperation between Democrats and Republicans will drive the speed at which changes are made in the 112th Congress.

#5 Quantitative Easing II (QE2)

One of the more significant developments in the second half of the year was the central bank's announcement of a second round of quantitative easing, commonly referred to as QE2. Fully admitting the rate of economic recovery was not as robust as expected, the Fed announced it will buy $600 billion of Treasuries through mid-2011 and will reinvest an additional $250 – $300 billion in Treasuries

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with the proceeds of its earlier investments in mortgage bonds. The explicit goals of the program include generating employment growth and bringing the core inflation rate closer to 2%. Through the purchase of Treasuries, it was the Fed's intent to lower mid- to long-term interest rates to meet these objectives, helping to fuel bank lending and increase the velocity of money throughout the monetary system.

How the economy and markets react to this most recent round of stimulus remains to be seen. Though, it seems like the combination of the second round of easing and the newly extended tax cuts may make for a more favorable environment. Although the stock markets have responded favorably, interest rates have not reacted the way the Fed had hoped, as the yield curve has actually shifted up since the announcement in early November. There are even rumors of a third round of quantitative easing despite the fact that QE2 has just begun. Eventually, a successful economy will need to wean off government support and be able to stand up and grow on its own.

#4 International Turmoil

The beginning of the year was led by squealing PIIGS (Portugal, Italy, Ireland, Greece and Spain) as the Greek debt crisis unfolded and downgrades ensued, with Moody's cutting the country's credit rating to non-investment grade by June. Although worries of default were diminished when the International Monetary Fund ("IMF") and European Union ("EU") announced a 110 billion euro rescue package, unease over the sovereign balance sheet positioning of other peripheral EU countries did not subside.

Spain was the next country to experience hardship, as high unemployment (above 20% early in the year) and debt troubles triggered credit downgrades in May. Portugal could not escape credit downgrades either, as investors feared a growing deficit. Fear eased slightly as Portugal announced it will cut its deficit to 4.6% of GDP by the end of 2011. However, doubts over the fiscal health in these countries prompted the EU to pass a 755 billion euro ($955 billion) bailout plan for the euro zone.

Moving into the fall months, the focus turned to Ireland as rating agencies downgraded the debt rating of this country as well. The Irish government voted to accept a 67.5 billion euro ($90.4 billion) bailout package from the IMF and EU and could cost the current prime minister, Brian Cowen, his job.

Rounding out the year, tensions mounted in the Korean peninsula as North Korea fired artillery on a South Korean island. Tensions have been stretched tight but, while escalation is not expected, this situation warrants monitoring into the New Year with implications stretching throughout the region. Either way, the uncertainty about Kim Jong-Il's next move makes this a situation to keep an eye on.

#3 The Aftershock of the Housing Bubble Remains

Some have described 2010 as a schizophrenic year for the housing market. The first half of the year showed promise, with homebuyers scrambling to purchase houses in time to qualify for the housing tax credit, while the second half was rather dismal, with housing starts and sales plunging after the housing tax credit incentive had expired.

Aside from a slowdown in demand for houses, current homeowners are also in some trouble. Currently, 22% of homeowners (10.8 million) have negative equity in their homes, owing more on their homes than their homes are worth. Further, foreclosures were rampant in 2010 and have been on a steady increase over the past few years: foreclosures in 2007 were up 75% from 2006. In 2008, they were up 81% from 2007. In 2009, they were up 21% from 2008. And it is estimated that in 2010, foreclosures will be up 5% from 2009.

Finally, even those buyers looking to buy a house in order to take advantage of the historically low mortgage rates are having some difficulty doing so. Lending standards have escalated substantially and banks and government entities are under heavy political pressure to avoid taking on additional risks. Moreover, bank appraisals have been a major challenge, as lenders keep changing their criteria of fair market value assessments.

With so many variables and contingencies, it is difficult to predict when housing will recover and just how long that recovery will take. There is currently a significant amount of inventory available, with even more on the sidelines as banks are holding onto foreclosed homes. Some have even predicted a double dip in the housing market, as the supply of homes is far greater than the demand, which will lead to a further reduction in prices. Let's just hope those people are wrong.

#2 The U.S. Economy's Recovery is Chugging Along…Slowly

The latest recession, more commonly known as "The Great Recession," resulted in a 4.1% decline in real GDP and was the longest recession in the post-war period. Only the Great Depression of the late 1920s – 1930s had a more debilitating effect on the economy. Needless to say, many had hoped for a relatively quick and robust recovery, but deep down knew this was very unlikely.

Prior to the 1990s, the average GDP growth in the first five quarters after a recession had ended was 5.6%. However, following the last three recessions, growth in the early stages of recovery has become quite muted. Following the recession that ended in 1991, the first five quarters of recovery showed 3.0% GDP growth and that number dropped to 1.9% following the recession that ended in 2001, both far below the historical average.

The economy's latest recovery from the "The Great Recession" shows GDP growth averaging 2.9% for the first five quarters, certainly not what many economists had hoped for. With unemployment elevated, GDP growth in the 4-5% range would be necessary to drive down unemployment. Growth in 2010 was disappointing, but economists are estimating the economy will grow even more in 2011. Just how much it grows remains to be seen.

#1 The Job Market

Despite all the positive news confirming economic growth, the benefits of a stronger economy may take longer to reach job seekers. With almost 15 million people unemployed, even a strong uptick in job growth will not be enough to keep a significant amount of people jobless for several years.

As we enter 2011, unemployment still remains at an alarming level of 9.4%. Put in perspective, the unemployment rate is 6% on average over the last 50 years. Over six million Americans have been unemployed for more than six months, the largest number since the government started keeping track in 1948. The average length of unemployment increased to 34.5 months in November from 29.4 months last year, which has led the Bureau of Labor Statistics to raise its maximum unemployment period in the surveys it conducts from two to five years.

Job growth in the private sector was somewhat disappointing in 2010 and any gains have not been large enough to make a significant dent in the unemployment rate. Moreover, the average number of initial jobless claims was trapped between 400,000 and 500,000 over the last year. Fortunately, that number has been trending down over the past few quarters as the number of Americans filing for unemployment benefits dropped to a level of 388,000 in the week of December 25th, marking the lowest level since July 2008.

The drop in initial unemployment claims is promising and economists are predicting a rise in 2011 hiring. But, with almost 15 million unemployed, it is clear it is going to take quite some time to get back to normal levels and that is if those normal levels are even attainable.

Outlook for 2011

It has been somewhat difficult to find economists and/or investment managers who do not expect 2011 to be a strong year for the equity market. Historically, the third year of a presidential term has been the best year by far. As evidence, following the past 12 mid-term elections since 1962, the S&P 500 Index was up 21% on average through the end of the third presidential year and rose all 12 times. During the same four periods, limited to the first term of the presidential cycle, the S&P 500 Index rose even more; 24% on average.

Moreover, the U.S. economic recovery seems to be moving along. Granted, the recovery is moving at a slower pace than usual, but economic data is trending positive and more and more uncertainty is being washed away. Corporations are posting solid earnings and are rich with cash, which at some point will likely be put to work, hopefully in terms of hiring. Additionally, manufacturing has been solid and retail spending has been surprisingly strong.

However, all of this optimism and good news may be reason to exercise caution as risks certainly linger. The job market remains the dark cloud that hovers above, with unemployment currently at 9.4%. The housing market is also a glaring issue as some argue we have yet to see the bottom of the market. Internationally, inflation in emerging markets countries threatens to stunt growth, the Eurozone debt crisis is far from over and geopolitical threats remain.

If history is any indication, 2011 should turn out to be a good year. However, as previously indicated, history told us that September and October should have been down months for the stock market in 2010 and ultimately history was proven wrong. This recovery has been anything but typical and despite the historical track record of the markets in the third year of a presidential term, the only thing that seems certain is this market is full of surprises, both good and bad.

An index is a measure of value changes in a representative grouping of stocks, bonds, or other securities. Indexes are used primarily for comparative performance measurement and as a gauge of movements in financial markets. You cannot invest directly in an index and, for comparative purposes; they do not reflect the effect of the various fees inherent in actual investment vehicles.

The S&P 500 Index is a market value weighted index showing the change in the aggregate market value of 500 U.S. stocks. It is a commonly used measure of stock market total return performance.

The Dow Jones Industrial Average is a price weighted index comprised of 30 actively traded blue chip stocks; primarily industrial companies, but including some service oriented firms.

Gross Domestic Product (GDP) is the market value of the goods and services produced by labor and property in the U.S. It is comprised of consumer and government purchases, net exports of goods and services, and private domestic investments. The Commerce Department releases figures for GDP on a quarterly basis. Inflation adjusted GDP (or real GDP) is used to measure growth of the U.S. economy.

The MSCI Europe and Australasia, Far East Equity Index (EAFE) is a market capitalization weighted unmanaged index developed by Morgan Stanley Capital International to measure approximately 1,100 securities in 21 major overseas stock markets. It is a commonly used measure for foreign stock market performance.

The MSCI Emerging Markets Index (EM) is a free-float-adjusted market-capitalization index developed by Morgan Stanley Capital International. It is designed to measure the equity market performance of 26 emerging market countries.

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