

## Executive Summary

The year started out strong on the heels of a year-end rally in 2010. By the end of February, the stock market had achieved its best annual start since 1998. Risky assets were performing well and positive progress was being made on the economic front.

Despite stock market gains, there were macro challenges and some pockets of weakness in the capital markets. Emerging markets and precious metals got off to a rocky start and municipal bonds were weak following sensationalistic forecasts of massive defaults and bankruptcies. Inflationary pressure in developing economies gained heightened attention and the Arab Spring kicked off with civil unrest across a host of Middle East and North African nations.

Additional headwinds surfaced in the spring. China, India, Brazil, and many other developing countries tightened monetary policy in an effort to contain rising prices. At the same time, Japan suffered massive earthquakes and a tsunami that took a tremendous toll on both human life and infrastructure. Oil prices spiked as Middle East conflagrations spread. Portugal kept the European debt crisis on the front burner by joining Greece and Ireland in seeking a bailout. There is little wonder why capital was driven into traditional safe havens such as gold, the U.S. dollar, and U.S. Treasuries.

Despite the headwinds, capital market returns were strong through April and momentum was good. The earnings outlook was positive, economic reports were good, and easy money continued to flow from the Fed. The good times would not last.

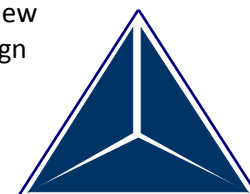
By May, monetary tightening was taking hold and Japanese related parts shortages and production shutdowns mounted. The labor market hit a wall, housing took a downturn, and the consumer was

fed up with high gasoline prices. In an unusual combination, global growth was slowing but inflation was still an issue. Central banks became increasingly hawkish and in what ultimately proved to be a mistake, the ECB raised rates to fight their own bout of rising prices.

Slower growth and economic pressure continued throughout the summer. Manufacturing slowed globally and European debt issues spread to Italy, Spain and France. Central banks got into gear. The ECB resumed purchases of troubled nation debt in an effort to limit interest rate spikes. The Fed, increasingly concerned about U.S. economic growth and the potential for a double dip recession, declared that interest rates would remain low for the next two years. The Board also initiated Operation Twist, a scheme to lower long-term interest rates by replacing \$400 billion of their shorter-term Treasuries with longer maturities.

Partisan, uncooperative, unproductive Federal debt ceiling debates resulted in Standard & Poor's downgrading U.S. government debt. A flight to quality ensued, market volatility rose tremendously, and risky assets were damaged. Pessimism reached a crescendo as the third quarter came to a close. The bad times would not last.

As October got underway, the domestic stock market was perched upon the precipice of bear market territory, a stock decline in excess of 20%. Excessive pessimism was washed out and the bears went into hiding. October clocked the best monthly return since December 1991. Economic data and macro news improved at that time as well. Employment, trade, consumer sentiment, inflation, and retail sales showed improvement. Better yet, Europeans had a new roadmap to deal with sovereign debt troubles.



In the final weeks of the year, the U.S. seemed to decouple from the rest of the world. Domestic leading economic indicators got a boost, consumer sentiment rose, industrial production was up, and holiday retail sales looked good. Mortgage delinquencies dropped, inflation ticked meaningfully lower, and the labor market improved. Overall growth for the year would come in at half the rate originally expected 12 months prior, but it was growth, and it accelerated at year-end. Domestic equity markets finished the year with modest single digit total returns. Considering the extreme levels of stock market volatility during the year, it is interesting to note that the S&P 500 index closed within 0.04 points of its starting level – its smallest price change since 1947 when it had no change at all!

Meanwhile, Europe's "having a plan to have a plan" was no longer acceptable to investors. Euro-zone bond markets melted down and Italian and Spanish yields spiked. What started in Greece had reached the heart of Europe. Major central banks announced decisive coordinated action to help ease financial strains and the ECB did all it could do to stem the tide.

In a similar fashion, emerging market policymakers grew concerned about slowing economic growth and their central banks universally reversed course to ease monetary policy. International equity markets dropped by 12.1% for the year. Emerging economies took the brunt of it, down over 18%, and many developing nation currencies weakened significantly.

As we look forward to 2012, global growth is expected to slow to a range of 3.0% to 3.5% while U.S. GDP is expected to grow by 2.0%. Europe will likely contract and we expect Japan to see slightly positive growth.

The domestic consumer's financial position has improved markedly and confidence is up. The

personal savings rate has diminished but is not in uncharted territory and is far from a crisis level. Labor markets remain weak but have shown significant improvement. For one thing, job growth in 2011 was sufficient to keep pace with population growth. While this does nothing to grind away at overall unemployment, it's a start, and a big improvement from recent years. Total employment, sitting at levels from 11 years ago, is disappointing and needs to improve.

Manufacturing is a mixed bag globally. U.S. industrial activity has slowed but remains positive. Many international economies are not as fortunate. Europe, Japan, Brazil, and China all measured contractions at various points in the second half of 2011. Concerns remain.

Housing took a leg downward in 2011 and prices sit at a new post-crisis low. Meanwhile, mortgage lenders have sorted through legal challenges and streamlined foreclosure processes. As they work through the large backlog of delinquent mortgages, foreclosures this year will grow versus last and housing prices will be under pressure.

Inflation appears to be headed lower and slowing global growth should help to hold commodity prices at bay. This eases pressure on the consumer and frees up central banks to pursue expansionary policies.

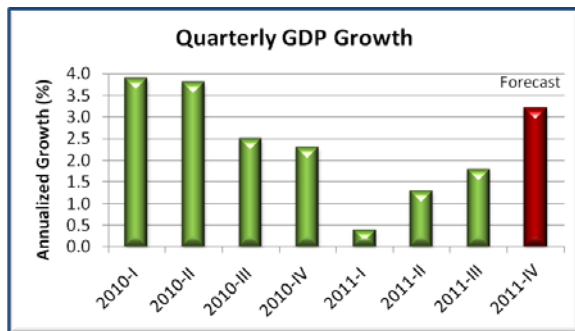
Lastly, the outlook for the European debt crisis is not favorable. Efforts to expand bailout facilities have failed and sovereign debt downgrades are prevalent and ongoing. The ECB is both unable and unwilling to act more aggressively and the current situation in Greece is untenable. Italy, the world's third largest government bond market, will have to raise €440 billion this year, €30 billion of which will come in the last week of January. Italy, both too big to fail and too big to bail, will be critical to watch this year.



## Economic Review and Outlook

### Economic Growth

U.S. gross domestic product (GDP) grew at an annualized rate of 1.8% in the third quarter of 2011. An acceleration of growth in the fourth quarter, to an expected annualized rate of 3.2%, will result in full year domestic GDP growth of 1.7% over that of 2010.



Data Source: U.S. Department of Commerce

Despite tepid growth through much of the year, real U.S. economic output reached a new high in the third quarter. That being said, GDP *per capita* remains 2.5% below the pre-crisis peak, comparable to the level in 2005.

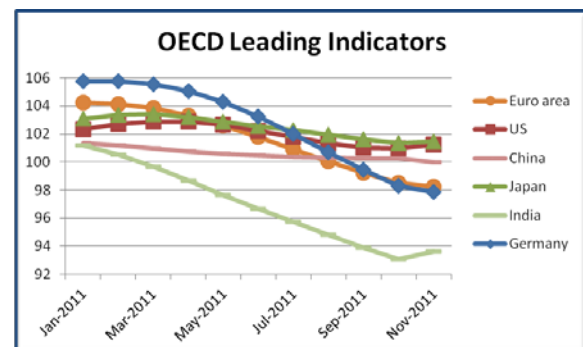
The fourth quarter's spike in growth is not expected to continue in 2012. European issues (debt & deficits, recession, fiscal austerity, restrictive credit, high unemployment, policy uncertainty, etc.) will shave off as much as 1.0% from U.S. growth. Domestic housing and employment remain negatives and inflation adjusted personal income fell for the year through November. The consumer's response, a lowered savings rate, is widely believed to be unsustainable. Furthermore, government actions will be restrictive this year. Fiscal policy is geared toward cuts at the federal level and many state and local governments are implementing austerity measures. The Federal Reserve, for all its bluster, has nothing left in the tank. All told, consensus expectations call for 2% U.S. growth for the year. It should be noted, this forecast anticipates a full year extension of the payroll tax cut and emergency

federal unemployment benefits. So far, Congress has only approved a two month extension. Failure to extend these programs for the full year would cut GDP growth by half.

International economic growth will also be restrained this year. Europe's emphasis is clearly on austerity rather than growth. The region's financial turmoil continues, confidence is weak, and growth of key trading partners, such as China, has slowed. Europe's GDP contracted by an estimated 1.8% in the final quarter of 2011 and is expected to shrink by 0.5% to 1.5% in 2012. Japan, the world's third largest economy contracted this year and is expected to grow only 0.5% in 2012.

Emerging markets are not immune to slowdowns in developed economies. Furthermore, inflation concerns caused many developing nations to implement restrictive economic policies during 2011. The combination of these forces will hold back emerging market growth to 5.0% or less this year.

The OECD's leading economic indicators add further emphasis to a theme of slower global growth in 2012. The organization's forecasting metric for the five largest nations as well as the combined euro-zone is shown in the following graph. In total, these regions represent 65% of world GDP. (The legend is ranked highest to lowest by economic output.)



Data Source: Org. for Economic Co-operation and Development

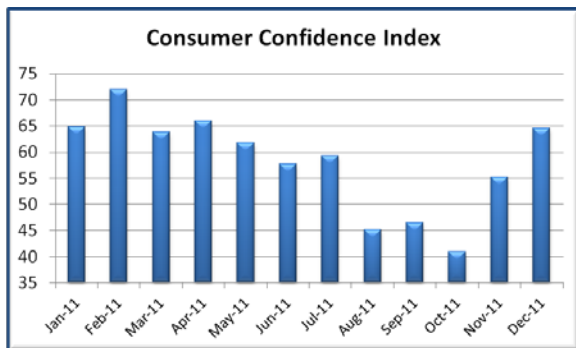


Two observations are noteworthy. First, the indicator dropped for every major economy by year-end. Second, the deterioration was particularly notable in India, Germany, and the euro-zone as a whole.

Factoring in slow growth in the U.S. and Japan, diminished growth in emerging markets, and recession in Europe, the IMF and OECD expect overall global growth to slow from 3.8% in 2011 to between 3.0% and 3.5% this year. A substantially lower range is possible, however, in the event of poor decisions and/or inaction on the part of global policy makers.

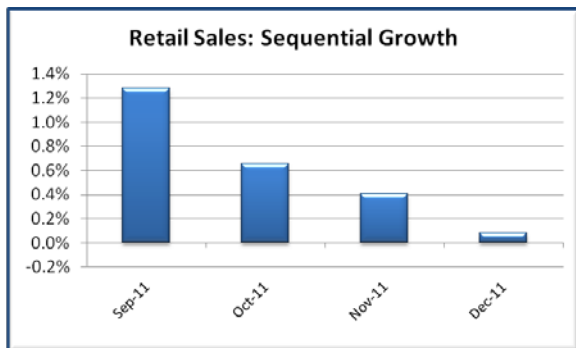
### The Consumer

After a generally downward trend for much of 2011, consumer confidence improved in the year's final quarter.



Data Source: The Conference Board

Oddly enough, despite improving confidence, sequential retail sales growth diminished during the same period of time.



Data Source: U.S. Census Bureau

Growth remained positive, however, as consumers saved less and spent more throughout the year. By November, the personal savings rate had dropped back to a pre-crisis level of 3.5%.

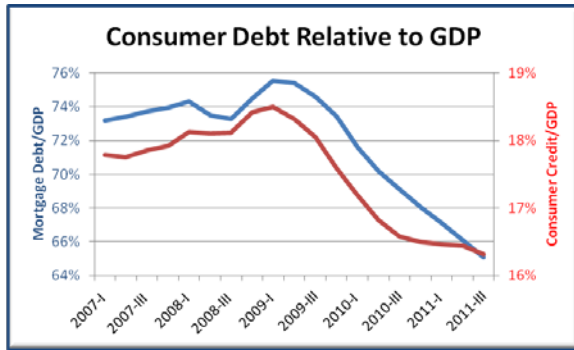


Data Source: U.S. Bureau of Economic Analysis

Many financial reporters and economists have declared this phenomenon as unsustainable. The economic comeuppance to such carelessness, they believe, will manifest itself through weaker spending as 2012 progresses. Caution is warranted, however, as a reversal, while both desirable and possible, is not guaranteed. The U.S. economy ran for a decade, from the late 1990's through most of the 2000's with savings rates at or below the current level. Furthermore, favorable consumer debt trends have enhanced household balance sheets and improved spending power. Delinquency rates on consumer loans and credit cards are well below pre-crisis levels and the consumer's ability to handle financial obligations, helped in part by low interest rates, has grown to levels last consistently seen in the early '80s.

Reflecting a stronger financial foundation, consumer credit, in absolute terms, has been on the rise for the past year. The pace of said growth has been modest, however, and overall household debt as a percentage of GDP has continued to fall.



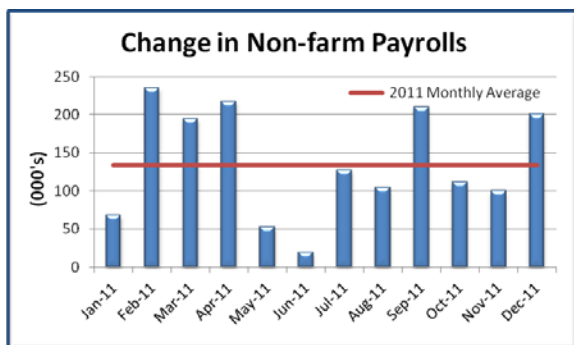


Data Source: U.S. Department of Commerce, U.S. Federal Reserve

Rather than a rise in the savings rate, disappointing future spending, if it happens, is more likely to come from a lack of real income growth. Through November, inflation adjusted personal income fell 0.4% in 2011. On a per capita basis, real personal income is back to a level first reached in 2006. Clearly, what happens in the labor market, discussed in the next section, drives personal income which, in turn, is crucial to the ultimate firepower of the consumer.

## Employment

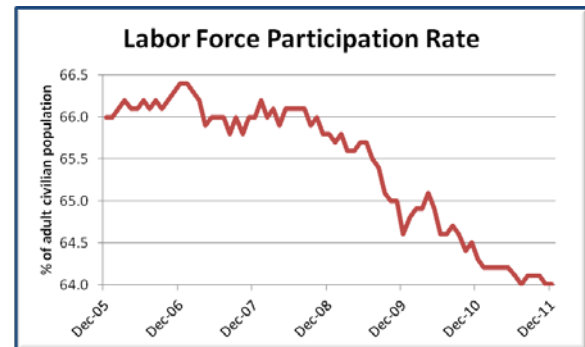
Labor markets improved in 2011. Average weekly hours returned to a pre-crisis level. The unemployment rate fell from 9.4% to 8.5% and the number of unemployed individuals dropped by 1.3 million. Initial jobless claims moderated slightly and payrolls grew by an average of 134,000 per month. As a matter of fact, every month showed job gains for the first year since 2005. In total, 1.6 million jobs were created for the period, 700,000 more than were generated in 2010.



Data Source: U.S. Department of Labor

Despite the improvement, a normal market requires about 125,000 new jobs to be created each month just to keep up with population growth. Thus, while the gains in 2011 were welcomed, they, in and of themselves, were insufficient to make a dent in unemployment.

So how did the unemployment rate drop by nearly 1.0%? Over 800,000 people either left the labor force or never bothered entering in the first place. This phenomenon, most clearly illustrated by a precipitous drop in the labor force participation rate, is not a reflection of a healthy labor market or a robust economy.



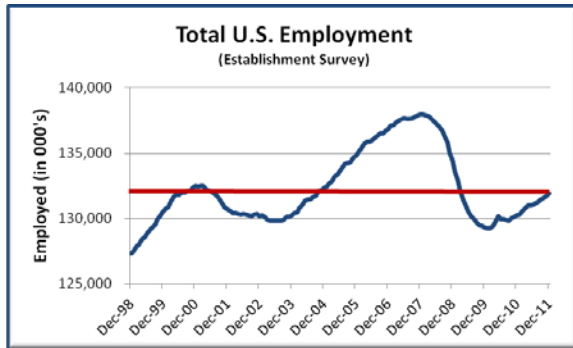
Data Source: U.S. Department of Labor

As shown in the graph, 2% of the adult civilian population has exited from the labor force since the start of the financial crisis. This seemingly inconsequential number adds up to a whopping 4.8 million individuals that, quite literally, no longer “count” to the Bureau of Labor Statistics.

So if the number of unemployed individuals can be deceiving *and* the resulting unemployment rate can be unreliable, how do we get a handle on the true health of the labor market? The answer is simple. Pay less attention to the unemployed and more attention to the employed.

As the following graph shows, total U.S. employment has gone precisely nowhere in 11 years!



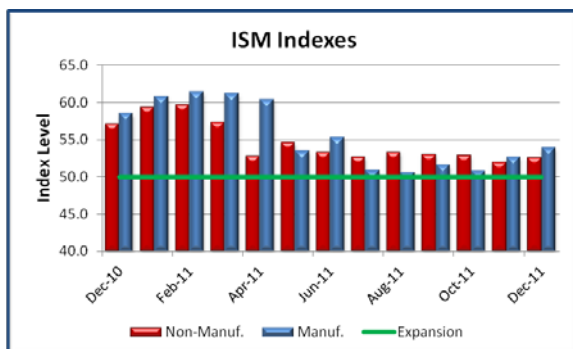


Data Source: U.S. Department of Labor

How do you avoid inadvertent distortions in labor market data? Focus on jobs. How do you assess the raw spending power of the consumer? Focus on jobs.

## Manufacturing and Service

Manufacturing led the global economy out of recession in 2009 and has been a relative bright spot in the economic landscape throughout the recovery. Growth remains positive in the U.S., albeit at a less robust pace. New orders, production, and employment were growing nicely at year-end and manufacturers reported much needed raw material price relief in the final quarter. Furthermore, inventory levels at both manufacturers and their customers were reported to be low. While this bodes well for potential replenishment, it is also a testament to forecasting uncertainty and caution on the economic outlook.



Data Source: Institute for Supply Management

Whereas U.S. manufacturing continues to show progress, the same cannot be said internationally. By the third quarter, global manufacturing was in contraction for the first

time in over two years as industrial activity in Europe, Japan, and Brazil began to decline. In the fourth quarter, China registered contraction as well. Slower global growth, high unemployment, and high commodity prices were key factors.

As with manufacturing, U.S. service industries continue to grow but at a slower pace. Likewise, we see further evidence of the U.S. decoupling from the rest of the world as exports are growing at a slower pace while imports are accelerating. This is a clear testament to more attractive relative growth dynamics in the domestic economy.

Unlike manufacturing, however, employment in the service sector began contracting in the final months of 2011. Reflecting on earlier comments regarding the importance of total employment, this is an unfortunate development – particularly considering the service sector accounts for over 86% of U.S. jobs.

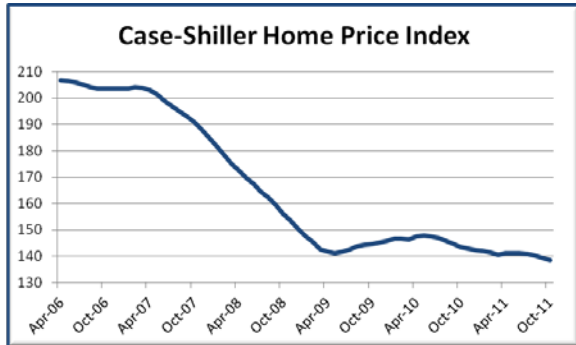
## Real Estate

Debate rages on the outlook for U.S. housing. Reports abound of the push by “smart money” investors and hedge funds into housing and construction related investments. The Dow Jones U.S. Select Home Construction index, for example, was up 32.9% in the final quarter of 2011 and a positive trend continues in January. That being said, as discussed below, only a soothsayer in possession of a highly reliable crystal ball could make the call for a turn in housing – the data suggests otherwise.

Year-over-year housing price declines of 3% to 4% were reported throughout most of 2011. Sequential monthly declines were ever present and the pace actually accelerated in the three month period ended in October. Prices fell in 80% of markets at that time. Barring one, prices have fallen for 17 months in-a-row. As the following graph shows, gains in 2009 have

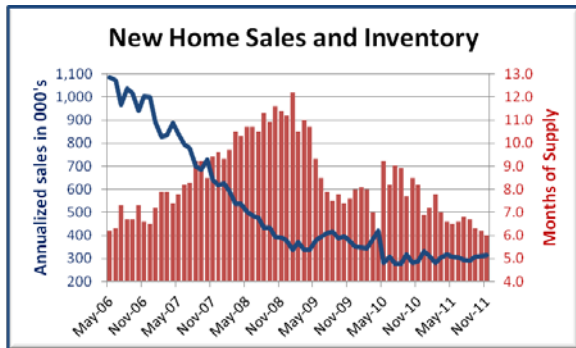


been given back and home prices hit a new low in October, down 33.0% from top.



Data Source: S&P/Case-Shiller

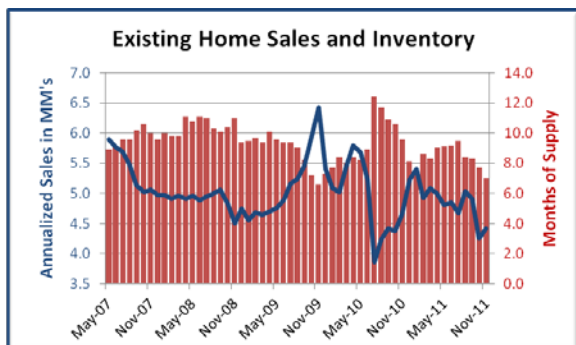
As for underlying fundamentals, new home sales have stabilized at an annualized rate of 300,000, down from 1.2MM prior to the crisis.



Data Source: U.S. Census Bureau

Inventory levels of new homes have fallen to a reasonably healthy level of six months of supply compared to a long term average of about four.

Sales and inventory levels of existing homes, shown below, each generally ticked downward in 2011.



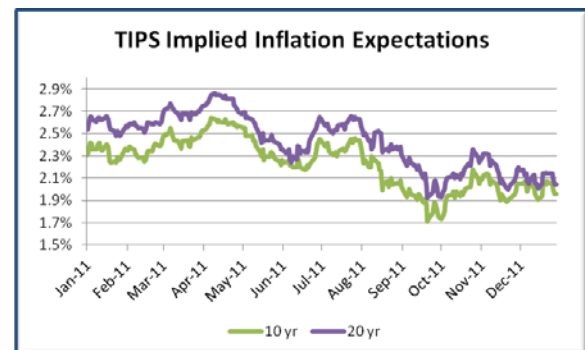
Data Source: National Association of Realtors

Although sales volumes are down and inventories are in good shape, mortgage delinquencies of 10.2% remain near the all time peak. As of September of last year, 6.4 million loans were delinquent or in default and 2.2 million homes were being repossessed by lenders. During 2011, foreclosures were delayed due to inadequate documentation and associated legal issues plaguing the lending industry. As the year progressed, however, the dysfunctional process improved. The net result is foreclosures will increase this year over last and the negative impact on prices will likely be more severe.

### Commodities and Inflation

Initially led by developing economies, inflation concerns ramped up early in 2011. By the end of the first quarter, developed nations became ensnared in rising prices as well. Central banks worldwide became increasingly hawkish and the IMF grew concerned that high prices would impact economic growth. China, India, Brazil, Korea, Thailand, and other developing economies aggressively battled inflationary pressures with restrictive monetary policy. The ECB, in its second ill-fated policy move in three years, joined the party early in the second quarter.

The Federal Reserve, to their credit, consistently maintained a posture that inflation was contained and expectations were appropriately anchored. The TIPS market was, and remains, in agreement.



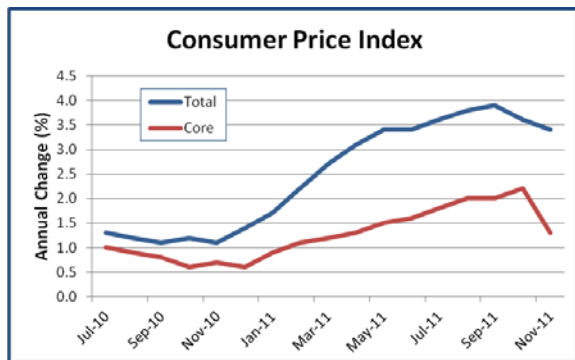
Data Source: U.S. Department of the Treasury



Bernanke argued that rising food and energy prices do not generally lead to broader inflation and that Fed policy is based on longer term expectations, not short-term movement. Furthermore, he believed the commodity price spike was transitory and no change in policy was warranted. He was right.

By May, cotton, sugar, lead, zinc, copper and other commodities were pulling back in dramatic fashion. Oil had experienced its steepest decline in two years and silver managed to drop 12% in 14 minutes and 20% in three days. In short, commodities were hammered.

By year-end, domestic inflation had begun to recede and commodities were by far the worst performing asset class within domestic investment markets.



Data Source: U.S. Department of Labor

Fearing they had overdone restrictive monetary policy, many central banks, including Brazil and China, began to ease by year-end. In a dazzling display of ineptitude, the ECB rolled back their own rate hikes just as they did with their previous ill-conceived hike in 2008 – rather disconcerting policy moves by the monetary authority for the world’s largest economic entity.

## Governments, Politics & World Events

Prior to addressing monetary and fiscal policy as well as the European sovereign debt crisis in

individual sub-sections, the following 2011 events bear mentioning:

- The year kicked off with civil unrest and violence in the Middle East and North Africa. Arab Spring, as it came to be known, accelerated into February with contagion engulfing an increasing number of the region’s countries. Hot beds of conflagration included Libya, Algeria, Egypt, Tunisia, Bahrain, Yemen, and Syria. Oil prices spiked and capital flocked to traditional safe havens such as gold, the U.S. dollar and U.S. Treasuries.
- Massive earthquakes hit Japan in March. Registering as Japan’s largest in recorded history and among the five largest for the world, the quakes kicked off a tsunami with waves as high as 33 feet. Thousands died in the disasters and extensive damage was inflicted on Japanese infrastructure, including four nuclear power plants. Global supply chains were hit by parts shortages and production shutdowns mounted. Autos and electronics were particularly hurt.
- Just prior to the ten year anniversary of the September 11 attacks, Osama Bin Laden was killed by U.S. Special Forces in May.
- MF Global, a major financial derivatives broker, filed for bankruptcy and regulators are investigating the potential of misappropriated client funds. The firm, headed by former New Jersey Governor and Goldman Sachs executive, John Corzine, went bust following massive ill-timed European sovereign debt bets.

## Monetary Policy

The second round of quantitative easing (“QE2”) came to completion as scheduled at the end of June. Investors wondering what would be next did not have long to wait. As the Fed grew more concerned about the economy in the third quarter, they announced two new plans in rapid succession. First, the Board assured that short-term rates would remain near zero through 2013. Next, a plan dubbed Operation Twist was hatched to replace \$400 billion of short-term Treasuries, currently on the Fed’s balance sheet, with longer dated maturities. The goal is to drive down long-term rates.



Another central bank initiative of late has been modification of how the Board communicates their views, policy, and future intentions. The first step, implemented last summer, was to provide public comments following Fed meetings. The second step, to be implemented with the first meeting of the new year, is to provide specific targets for monetary policy and more explicit goals for inflation and employment. The intent of more open communication is to reduce uncertainty and related volatility by enhancing transparency.

As the year drew to a close, there was increased discussion, both inside and outside of the Fed, of the possibility of a third round of quantitative easing. Should such a move take place, expectations are that it will be focused on the mortgage market.

### **Fiscal Policy and Legislative Activity**

The U.S. deficit for the fiscal year came in at \$1.3 trillion, or 8.5% of GDP. Spending at 23.8% of GDP was above historical average, revenue of 15.3% of GDP was below average, and the net deficit relative to GDP was the third highest out of the past 65 years. Federal debt is now 100% of GDP for the first time since WWII.

Despite staggering debt and deficits, the U.S. economy needs a combination of short-term stimulus and long-term deficit reduction. In a highly leveraged economy, fiscal policy is the only thing that works to spur growth as monetary policy will not create final demand. Despite such a textbook approach of countercyclical government spending, most U.S. policymakers are intent on doing just the opposite. During debt ceiling discussions last summer, “cut, cap, and balance” became the mantra for many. Cut the federal budget, cap future spending, and agree on a balanced budget amendment before raising the debt ceiling.

While falling short of cut, cap, and balance, the debt ceiling debate did conclude with an 11<sup>th</sup>

hour agreement sufficient to raise the debt ceiling and sidestep a default. That being said, for all the hemming and hawing, very little was actually accomplished. A roadmap of sorts was laid out to cut \$2.4 trillion over 10 years, but details were left in the hands of a 12 member special committee. The group, unidentified at the time, was tasked with delivering a final plan by November 23. The super committee, as they came to be known, failed. The result is pre-defined, automatic, somewhat draconian spending cuts from various programs will now take place starting in 2013. The lack of nonpartisan cooperation undermined global confidence in U.S. lawmaking resulting in Standard & Poor’s downgrading U.S. long-term government debt to AA+ with a negative outlook.

Faced with year-end expirations of both the payroll tax cut and federal emergency unemployment assistance, Congress passed a two month extension of each. Failure to extend these programs for the full year will result in significantly lower GDP growth than currently expected.

A highly partisan climate in Washington will add tremendous political uncertainty during an election year when Congress attempts to tackle:

- Bush tax cuts expiring at year-end
- Further extension of the payroll tax cut and emergency unemployment benefits
- Modifications to debt ceiling related automatic spending cuts

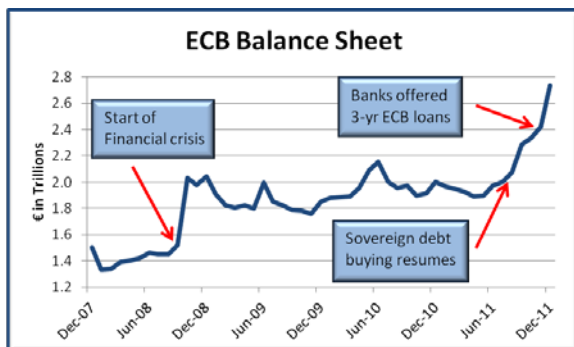
### **The European Crisis**

By mid-year, ever-present European sovereign debt issues had worsened. Spain was a rising concern and Portugal joined Greece and Ireland in seeking bailout funding. Greece, in rapid decline as a result of severe austerity measures, realized it would require more than the prior year’s €110 billion bailout. The country got back in line to pursue a second package, this time in the amount of €130 billion.



By August, European debt concerns had spread to Italy, Spain, France, and European banks. Scores of sovereign debt downgrades ensued. There are too many to chronicle and they continue as we go to print. In an effort to restrain spiking interest rates, the ECB resumed buying troubled nation bonds, this time with an emphasis on Italian and Spanish securities. However, concerned about moral hazard and the lack of an appropriate mandate, the ECB has limited purchases to about €20 billion per week – an insufficient amount to restrain rates from rising to unacceptable levels.

The ECB's measured pace has not prevented its balance sheet from ballooning. It has doubled since the start of the financial crisis and the recent uptrend, shown in the following graph, resembles the much maligned hockey stick formation.



Data Source: European Central Bank

Assisting in the growth of the ECB balance sheet was a newly initiated program whereby the central bank offered unlimited three year low interest rate loans to commercial banks. To help facilitate the uptake, which was a phenomenal €489 billion, commercial bank reserve requirements were cut and the pool of acceptable collateral was widened. The goal of this program was simple: If the ECB is unable or unwilling to buy sovereign debt in sufficient size, then provide unlimited cheap financing to banks so they can do the dirty work.

Although well intentioned, adding sludge to European bank balance sheets only adds to an

escalating problem. Capital is drying up for these institutions out of fear of the assets they hold. Depositors, U.S. money market funds, and even other banks are hesitant to provide money to European banks. Ironically, ECB loans are even harder to come by as banks have depleted eligible collateral. In response, banks are building and/or hoarding capital and excess funds are being parked with the ECB.

As for solutions outside of the ECB, Germany and France worked during the final quarter of the year to 1) find a lasting solution to Greek debt issues, 2) recapitalize euro zone banks so they can withstand sovereign defaults, 3) maximize the firepower of the bailout fund, and 4) speed euro-zone fiscal integration.

Unfortunately, political, constitutional, and economic barriers to success are huge. Germany prefers a national solution and is against a larger bailout fund, euro-bonds, and greater ECB intervention. France is at the opposite end of the spectrum on each point.

In short, the outlook is not good. It is no longer good enough for European policymakers to “have a plan to have a plan.” Efforts to expand Europe’s bailout fund have come up short. If anything, the fund’s size likely diminished as a result of France’s recent credit downgrade from AAA. The prospect of euro-zone bonds died quickly and the ECB is unable and unwilling to act in a larger capacity. The hope for private holders of Greek bonds to take a “voluntary” haircut has hit a brick wall. In response, Greece sent out an S.O.S.

As things stand currently, the somewhat academic question of whether any governments would default has been supplanted by several new ones. How large will the defaults be? Will they be forced restructurings or voluntary? Will the euro survive?



## Capital Markets Review and Outlook

### Overview

The year started strong on a continuation of the year-end rally in 2010. Through February, the stock market had its best start since 1998. Commodities also performed well. Municipal bonds, on the other hand, showed weakness early on from a combination of the expiration of the Build America Bond program as well as sensationalistic analyst reports calling for massive losses in the space. Emerging markets were weak due to the Arab Spring, concerns of overheating inflation, and resulting restrictive monetary tightening.

Solid returns continued for domestic stocks until May. At that time it was as if someone threw the gears into reverse. Diminished growth became evident, labor markets stalled, commodities hit a wall, manufacturing and service slowed, consumer confidence dropped on high gasoline prices and housing resumed a downward trend. Japan related supply disruptions were evident and widespread monetary tightening was taking hold.

By late summer, European debt issues had spread from peripheral countries to the core. Insane volatility prevailed in the markets. In the U.S., fears of a double dip recession were mounting and the country's debt downgrade did not help. By the end of the third quarter, excessive pessimism prevailed and bears took command of Wall Street. The table was set for a fourth quarter rally. Domestic stocks cranked out double digit returns in the final three months of the year. Even beleaguered international equities rose modestly.

By year-end, massive municipal bankruptcies had failed to show up and municipals bonds had rallied to become the best performing major asset class; emerging market equities remained weak. As for developed markets, high market correlations in recent years fell apart as domestic equities decoupled from their international counterparts. U.S. stocks delivered modest single digit positive returns while international stocks performed poorly, declining by double digits. Commodities

remained weak on a pullback from excessive levels in the first quarter along with fears of global slowing. Questions on the ultimate impact of China's monetary tightening, resulting in either a soft or hard landing, remain.

### Fixed Income Markets

Most fixed income segments generated mid

single digit returns for investors in 2011. Municipals and TIPS were particularly strong performers in the group, along with anything with a long duration. High yield debt spreads have backed off from higher levels, but remain nicely above the long-term average. Likewise, corporate bonds may offer potential considering they have only been this cheap relative to Treasuries 10% of the time over the past 20 years. The 10-year Treasury yield ended the year with a yield of 1.89%, down 141 basis points for the year.

### Equity Markets

U.S. stocks delivered modest single digit positive returns while international stocks fell by 12.1%. Emerging markets were the laggards

Capital Market Returns

	4 <sup>rd</sup> Qtr 2011	Year-to- Date
U.S. Treasury Bills	0.0%	0.1%
Barclays Aggregate Bond	1.1%	7.8%
Barclays Municipal Bond	2.1%	10.7%
S & P 500	11.8%	2.1%
Dow Industrials	12.8%	8.4%
MSCI EAFE (Int'l Equities)	3.3%	-12.1%
MSCI EAFE Emerg. Mkts	4.4%	-18.4%
DJ UBS Commodity Index	0.4%	-13.3%

Data Source: Morningstar



of equities, dropping by 18.4%. The outlook for equities is uncertain as economic growth will slow in 2012 and corporate profit margins have little room for upside. Earnings estimates for the fourth quarter have also shown an uncharacteristic pattern of downward revisions. This may pose challenges in the coming earnings release season. On the other hand, valuations have contracted and reports suggest companies have already started restructuring activities in expectation of slower revenue growth in 2012.

### **Hedge Funds and Alternatives**

For the most part, these categories were challenged in 2011. The HFRI Fund of Funds index declined 5.5%. Long/short equity managers had particular trouble as dramatic market swings were driven by unpredictable

macro events rather than company and industry fundamentals. Managed futures, subject to the same unpredictable forces, were whipsawed by swift trend reversals.

Commodities were down over 13% with some segments falling spectacularly more. Copper, cocoa, and cotton paced declines falling 23%, 31%, and 37%, respectively. Tin, nickel, zinc, silver, platinum, and palladium were all down, in some cases by over 20%. The energy complex was mixed, however, as natural gas fell 31% but oil rose by 10%. Accompanying oil on the positive side were gold, up 10%, and cattle, gaining 12% on a shrinking U.S. herd.

Following two strong years of performance, publicly traded REITs were down mid single digits for the year.

### **Disclaimers**

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