

Fourth Quarter Equity Market Review and Outlook

Quarterly Equity Market Review

Stocks closed out 2010 in style with most indices recording solid double digit quarter (and year) performance. The rally was set in motion with the announcement of the Fed's quantitative easing intentions in August and brought the market to levels not seen in over two years.

Four basic themes dominated the headlines, and thus trading activity, throughout the quarter: Europe and its sovereign debt woes; changes in Washington, specifically the fate of the Bush tax cuts and expectations for the new Congress; monetary tightening in emerging market economies; and finally (and we think most importantly), an improvement in economic news flow. The better than expected economic data late in the year signaled a reacceleration in the global economy and helped to trump the multitude of secular headwinds.

Persistently high stock correlations amongst asset classes finally abated somewhat this quarter, a welcome sign for a more discerning marketplace. Corporations began to utilize their sizable cash balances and re-tooled balance sheets and sparked an M&A push (particularly in the Technology sector). Fund flows, a headwind for domestic equities for the past 12 months, turned positive late in the quarter. Growth stocks outperformed value stocks this quarter (and year), while small caps outpaced large caps by a wide margin.

Equity Market Outlook

We suspect more gains are in store for stocks this year... but it won't come easy. Much like 2010, positive returns will disguise plenty of intra-year volatility. The headwinds for stocks (European debt concerns, a China growth scare, housing double dip, etc.) are real, but so is the recovery. Undoubtedly, these opposing economic forces will again clash, leaving investors to ponder their ultimate impacts. The incoming data will provide fuel for bullish and bearish

outlooks and will test the current market equilibrium. For example, manufacturing PMI's will accelerate, but inventories will begin to creep up. An improving jobs outlook will be tempered by higher forecasted savings rates. Profits will grow again, but peak margins will cause investors to question the sustainability. We expect healthy debates around the macro releases, with plenty of market volatility. Ultimately, if government support continues unabated, we think stocks will continue to behave like typical post-war recovery years, even if the economy is unusually weak compared to past recoveries. With correlations falling and valuations now fair, stock selection and active management will be the keys to a successful year.

Growth reaccelerated late in the year and there now appears to be more upside risk to profit estimates than downside risk, at least in the near term. By maintaining a cyclical growth bias, we have positioned our portfolios to

benefit with continued signs of an economic recovery. We will be watching the data to see if we are indeed transitioning from a recovery to expansion, as factor performance will change. We have emerged from the deepest recession in half a century, but considerable skepticism and doubt has been a constant, helping to keep a lid on multiples. We don't see that dynamic changing anytime soon, therefore stock selection will be key. A prolonged period of growth, accompanied by increased confidence and a better jobs picture, will be the ingredients needed to sustain this recovery and drive further gains in stocks.

We are happy to share our thoughts with you in greater detail and welcome any questions and comments you may have. Thank you for your continued support.

Equity
COMMENTARY

By Doug S. Couden,
*Director of Equity & Senior
Equity Portfolio Manager*