

**P E R S P E C T I V E S**

January 31, 2011

**Executive Summary**

The year 2010 unfolded much as we expected. Accommodative policy, low inflation, and moderate economic growth provided a favorable environment for risk assets, which offered healthy returns even in the face of market volatility. Our central investment thesis entering 2011 is that the recovery should remain sustainable in the absence of any policy mistakes or major shocks to the economy but that it will be moderate, fragile, and uneven. Low inflation, accommodative policy, and moderate economic growth should continue to favor select risk assets over the near term, but changing events and circumstances could force us to assume a more defensive posture at any time. We remain particularly concerned about persistent weakness in Europe, potentially overheated economies in China and other emerging markets, and certain structural imbalances in the U.S.

**Review**

For the past two years, we have written about the stimulative environment for risk assets created by global policymakers. In 2010, favorable monetary and fiscal policy continued to bolster the financial markets, leading to a second year of the bull market that began in March, 2009.

**U.S. Equities.** Sustained by improving earnings and economic conditions, the U.S. equity markets continued their climb during the first quarter of 2010. In May, however, European weakness pressured the global financial markets and threatened to end the rally in equities and other risk assets. Nevertheless, European governments responded with a bailout package for Greece, the European Central Bank began to purchase government bonds, and the financial markets generally responded favorably.

The U.S. equity markets then resumed a downward trajectory on concerns surrounding housing and unemployment, which exacerbated fears of another recession. Again, however, policymakers stepped in to halt the decline when the Federal Reserve decided to purchase long-term Treasury securities (QE2) to keep interest rates low, force the dollar to drop, and cause risk assets to appreciate.

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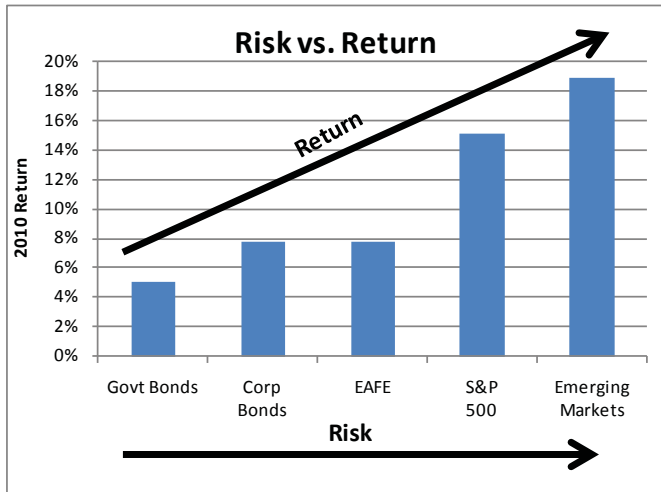
With renewed support from the Fed, the U.S. equity markets moved upward throughout the remainder of 2010. They received further fuel when, in December, the President and Congress agreed to an additional stimulus package in the form of a one-year payroll-tax reduction and a two-year extension of the Bush income tax cuts.

For the year, the Dow Jones Industrial Average was up 14.1%, returning to levels not held since the collapse of Lehman Brothers in 2008. The S&P 500 Index and the NASDAQ Composite Index also posted sizeable gains, returning 15.1% and 16.9%, respectively, for the year.

**U.S. Fixed Income.** As demand for risk assets intensified during the third and fourth quarters of 2010, the fixed-income markets generally underperformed the equity markets. Nevertheless, fixed-income investors were the beneficiaries of respectable annual returns.

Corporate debt outperformed government debt in 2010. Returns on corporate bonds were fueled by strengthening corporate balance sheets, expectations for moderate growth, low inflation, and uncompetitive yields on cash.

For the year, the Barclays Capital Intermediate Credit Index of corporate bonds was up 7.8%, and the Barclays Capital Intermediate Government/Credit Index of government and corporate bonds was up 5.9%. The Barclays Capital Intermediate Government Bond Index was up 5.0%, and the Barclays Capital 1-10 Year Municipal Blend Index, which includes municipal bonds from around the country, was up 3.1%.



**Real Assets.** Commodities rallied alongside other risk assets for much of 2010. The rally was stronger for some commodities than others but generally was fueled by the confluence of a declining dollar, strong demand from China and other emerging markets, and growing confidence in the global recovery. The Dow Jones UBS Commodity Index rose 16.8% in 2010.

Oil traded in a narrow range throughout the year, as record demand from the emerging markets was offset by record stockpiles in the developed markets. Oil finished the year at \$91.38 per barrel, a gain of 15.1% for the year.

Emerging-market demand also led to higher prices for certain industrial metals, including copper, which rose 33.4% in 2010. For the year, gold climbed 29.5%, to \$1,421.10 per ounce, as investors worried about inflation in China, economic uncertainties in Europe, and the trend of central banks attempting to devalue their currencies.

With regard to real estate, select commercial real estate markets showed signs of improvement in 2010, but vacancy rates remained near historic highs. Residential real estate prices were stable for much of the year but declined slightly later in the year.

**U.S. Dollar.** As the euro zone countries dealt with their budgetary problems, the euro fell 6.5% against the dollar during 2010. In contrast, the dollar lost 12.7% against the yen, even in the face of a weakened economy in Japan. For the year, the U.S. Dollar Index, which measures the dollar against a basket of currencies, gained 1.5%.

**International Markets.** Global financial markets generally performed well in 2010, but there were significant divergences. The MSCI EAFE Index of developed economies gained 7.8% for the year, while the MSCI Emerging Market Index gained 18.9%.

Among the European stock markets, those of Greece, Spain, Italy, Ireland, and Portugal all suffered losses in 2010. Major indices in Denmark, Germany, and the U.K., however, rose 35.3%, 16.1%, and 9.0%, respectively, in local-currency terms.

In Asia, strong recoveries and increased interest from global investors drove market indices in Indonesia, South Korea, and India up 46.1%, 21.9%, and 17.4%, respectively. Nevertheless, China's Shanghai Composite fell 14.3%, and Japan's Nikkei Stock Average lost 3.0%.

## Analysis

One year ago, we wrote that “We believe that there remains much to be optimistic about in 2010. Nevertheless, there is considerable uncertainty about the next few years, and we expect that, relative to past recovery periods, growth could be subdued, particularly in light of continued deleveraging, high unemployment, and softness in the U.S. real estate markets.” We opined that “in 2010, unless there is a substantial change in circumstances, governmental policy should remain accommodative, inflation should remain contained, and the dollar's decline should be orderly. Given these conditions, we favor carefully selected equities, corporate bonds, and other risk assets as part of a longer-term, diversified portfolio strategy . . .”

The year 2010 unfolded much as we expected. An environment of accommodative policy and low inflation did favor investments in carefully selected risk assets. Returns were healthy, and market volatility did persist, particularly as the European sovereign debt crisis intensified.

Our central investment thesis entering 2011 is not dissimilar, albeit with certain caveats. We expect the recovery to remain sustainable in the absence of policy mistakes or major shocks to the economy (geopolitical or otherwise), but we expect it to be moderate, fragile, and uneven. Provided that the general conditions of low inflation, accommodative monetary policy, and moderate economic growth persist, we continue to favor select risk assets.

Nevertheless, our current outlook must be qualified by certain concerns that we have. First, we remain concerned about persistent weakness in Europe and the failure of European policymakers to act more swiftly to address the lingering problems in Greece, Ireland, Italy, Spain, Portugal, and other countries. Second, we remain concerned that China and other emerging market economies have grown too quickly, thereby forcing policymakers to tighten fiscal and monetary policy in a manner that could cool those economies and lead to a “hard landing.” Third, we

remain concerned about certain imbalances in the U.S.

As a result of these concerns, we are qualifying our cautiously optimistic outlook for risk assets with a shorter time horizon. We are not necessarily predicting a deterioration of the current financial environment, which, under the right set of conditions, could continue to be positive for some time. We merely wish to emphasize that it has become increasingly difficult to offer longer-term forecasts. Changing circumstances are causing us to make a small allocation to more defensive investments and could force us to assume a more defensive posture at any time.

**Our call for additional vigilance during 2011 is based on a convergence of potential problems that could interrupt the longer-term recovery process.**

*Europe.* In some respects, we view the European sovereign debt crisis as a continuation of the global crisis that erupted in 2008. Overleveraging, fiscal extravagance, and depressed asset values are the core of Europe's problems.

Yet, even in the face of declining prices and falling wages, the European Central Bank has been slow to respond. In part, this reluctance is likely attributable to a dichotomy: certain countries, such as Germany, do not require the same level of stimulus as other countries, such as Greece. Simultaneously, fiscal austerity measures adopted by several European countries are aggravating the economic recoveries in those countries, leading to job losses, depressed wages, and reduced spending.

In our view, the European sovereign debt crisis will continue for the foreseeable future until European policymakers decide to respond with additional relief. In the meantime, investors should be prepared for periods of uncertainty and accompanying volatility.

*China and the Emerging Markets.* While many European economies are experiencing low growth rates and appear to require stimulus measures, many emerging-market economies are experiencing high growth rates and appear to require dampening measures. In China, for example, consumer spending is up sharply, and food prices have risen dramatically, climbing 11.7% in November alone. Real estate prices also have soared, rising some 50% in major cities over the past year.

In response, Chinese policymakers have scaled back prior stimulus programs, raised interest rates, tightened the standards for real estate loans, and taken measures to limit real-estate speculation. Yet, it would appear that further tightening can be expected.

As we have noted on several occasions, the emerging markets have been key to the global recovery. Thus, policy restraint within the emerging markets, while arguably necessary for those markets, is a significant concern for the rest of the world. The possibility of retarding growth within some of the world's primary growth engines could weigh on the global financial markets in 2011.

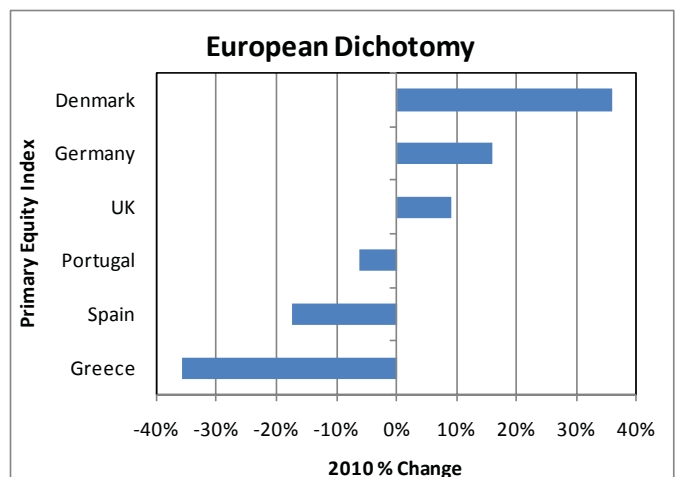
*The U.S.* Within the U.S., we remain concerned about several phenomena. We have written that, in our opinion, a strong economic recovery cannot occur without the support of the consumer sector, which, in turn, necessitates stronger employment. Yet, employment growth has been sluggish. For example, while the unemployment rate, as reported by the U.S. Bureau of Labor Statistics, fell to 9.4% in December, nonfarm payroll employment was up by only 103,000 for the month, with growth generally limited to the leisure and healthcare sectors.

We also continue to be concerned about housing, the epicenter of the crisis that led to the Great Recession. Home prices have declined again; mortgage rates have risen; and data relating to home sales, inventories, building permits, and mortgage applications all suggest that the housing sector remains weakened.

Finally, we believe that the U.S. deficit and national debt are approaching unsustainably high levels. Policymakers, however, have yet to offer credible, long-term solutions to these problems, and, in our opinion, until they do, the financial markets will continue to suffer from volatility.

**While the above risks must continuously be monitored in 2011, there remains substantial cause for optimism, particularly in the U.S.**

*Low Inflation and Accommodative Monetary Policy.* Inflation in the developed world remains contained. As a



result, it is likely that monetary policy will remain accommodative in 2011, with key interest rates unlikely to rise in the U.S. or Europe for the foreseeable future. While monetary policy is likely to be tightened in certain emerging markets, our view is that such tightening generally should not halt future growth. Furthermore, the global backdrop of low interest rates is likely to remain for some time, continuing to bolster the emerging markets.

*Stabilized Savings Rate.* We previously have written about consumer deleveraging as a threat to growth in the U.S. Specifically, as the U.S. savings rate spiked up in 2008, U.S. consumers dramatically reduced their consumption in favor of saving more money. Since 2009, the U.S. savings rate has leveled off at approximately 6%. A steady savings rate of approximately 6% should mean that consumers can shed debt while also resuming more normal spending levels. BCA Research estimates that at the current savings rate, consumers will have reduced their net debt by over \$2 trillion in three years.

*Low Cash Yields.* Cash and cash equivalents continue to offer virtually no yield, intensifying the pressure on holders to seek higher returns. Eventually, much of the cash held by reluctant investors should find its way into riskier assets, including equities, driving prices higher.

*Favorable Business Conditions.* Corporate profits have continued to strengthen, with many companies making significant productivity gains. In fact, while weakened labor markets remain a longer-term cause for concern, shorter-term they should allow labor costs to remain relatively low. Furthermore, lower interest rates have made borrowing relatively inexpensive for many companies.

*Strong Balance Sheets.* By some measures, nonfinancial companies are as flush with cash as they have been in five decades. In addition to being available for stock redemptions, dividends, and acquisitions, this excess cash can be utilized for capital spending, which, in recent months has been accelerating, fueled by lower borrowing costs, depleted stocks, and improving profits. A powerful rebound in capital spending could provide an additional boost for the recovery in 2011.

*Weaker Dollar.* The dollar's decline since 2008 has, in all likelihood, contributed to the recovery of the U.S. economy. A lower dollar has made U.S. exports increasingly competitive, a fact that should not be understated. Some sources estimate that nearly 50% of the earnings of all S&P 500 companies are derived from abroad, and accordingly, more competitive exports translate directly to higher earnings for U.S. companies. Higher earnings should lead to higher employment, and higher employment should lead to a stronger housing sector.

*Reasonable Valuations.* As of December, the S&P 500 was trading at approximately 13 times forward earnings. By historical standards, this remains a reasonable valuation when compared to the median multiple of about 16 during the past decade.

## Conclusion

Within the U.S., we currently expect the recovery to continue in moderate, but uneven, fashion absent any policy mistakes or major shocks to the economy. Nevertheless, we remain concerned about unemployment, housing, and high budget deficits. We are less optimistic about Europe, but we remain optimistic about the emerging markets.

Concerns about European weakness, overheated emerging markets, and structural imbalances in the U.S. are cause for increased vigilance, but we believe that current conditions remain favorable for select risk assets. In our opinion, the U.S. equity markets should continue to benefit from rising earnings, strengthened balance sheets, low inflation, accommodative monetary policy, and moderate economic growth. Internationally, we continue to favor select developed and emerging markets, with an emphasis on the emerging markets and a range of commodities that can benefit from increasing emerging-market demand. With respect to bonds, our view is that Treasury bonds will underperform as the economy continues to recover. Having performed well in 2010, returns from corporate bonds may be more subdued.

As circumstances change, we are prepared to assume a defensive tactical posture if necessary. We note again, however, that the best defensive strategy is to maintain a diversified investment portfolio.

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Sources: BCA Research, FactSet, Bloomberg, the *Wall Street Journal*, *Baron's*, Bureau of Economic Analysis.

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