

Stock Market: Quarter in Review

- After a harsh third quarter with the major indices registering double digit percentage declines, equities stormed back in October with their strongest monthly gain in over 20 years.
- The combination of a perceived improvement in the European debt crisis, better domestic economic news, high negative sentiment, and a strong technical bounce off critical support provided fuel for the explosive rally.
- Stocks then bobbed back and forth inside a large trading range for the rest of the quarter but still logged impressive gains while closing near the flat line for the year.
- Correlations remained at elevated levels after spiking to all-time highs during the third quarter swoon.
- Despite an October rally, the full year returns for riskier, more cyclical, and higher volatility strategies lagged their more stable counterparts by a dramatic margin.
- Value and small cap outperformed growth and large cap for the quarter but lagged significantly for the year.
- Top sector performers for the quarter were consumer discretionary, energy, and industrials while the more defensive consumer staples, healthcare, and utilities were the clear annual winners.

Stock Market: The Quarter Ahead

- While the final numbers for the year in the equity markets misleadingly suggest that not much happened in 2011, the dramatic volatility and rotation to safety were notable as the European debt crisis and domestic economic growth concerns swamped the headlines and dominated investor attention.
- Equities have held up well considering the rallies in safe havens such as Treasuries, the dollar, and the volatility indices.
- The inability of correlations to decline meaningfully from historic highs could make stock picking more difficult and be a harbinger of further volatility.
- Valuation and corporate earnings in concert with low interest rates remain generally supportive factors for stock market gains. Progress on the European debt crisis and better than expected economic news could act as catalysts for a resumption of the bull market.
- However, the substantial underperformance of cyclically oriented sectors compared to more defensive ones suggests continued investor concerns about growth prospects going forward.
- Additionally, the damage done during the August selloff and the ongoing trend of higher volume sell offs and weaker volume rallies within the large trading range that has held prices since are sources of potential strain should the October lows give way.
- Equities enter 2012 with investors hoping that the volatility and flat performance in 2011 were just part of a consolidation of the gains from the previous two years and that the October lows will not be eclipsed. However, significant global and economic risks persist that could make further gains more challenging in the coming year.

4th Quarter Scorecard

Table 1

Index	Quarter	1 Year
S&P 500	11.8%	2.1%
Russell 1000	11.9%	1.5%
Russell 2000	15.5%	-4.2%
Russell 3000	12.1%	1.0%
Russell 3000 Growth	10.9%	2.2%
Russell 3000 Value	13.3%	-0.1%
Barclays Capital US Aggregate	1.1%	7.9%
3 Month T-Bills	0.0%	0.1%

The Economy: Less Bad

It certainly doesn't feel like it, but the U. S. Economy is officially 2 ½ years into the recovery. Conditions have improved somewhat during the past several months and the threat of a so-called double dip recession appears to have abated, for now. Nevertheless, the pace of recovery remains anemic by virtually any measure. Moreover, significant risks remain. Our overall observations are summarized below:

- Employment trends have improved marginally but remain far below normal. Of the previous five recessions, the only instance of such anemic employment growth was the "double dip" recession 1981-82 experience (See Table #3).

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Interest Rate Summary

Table 2

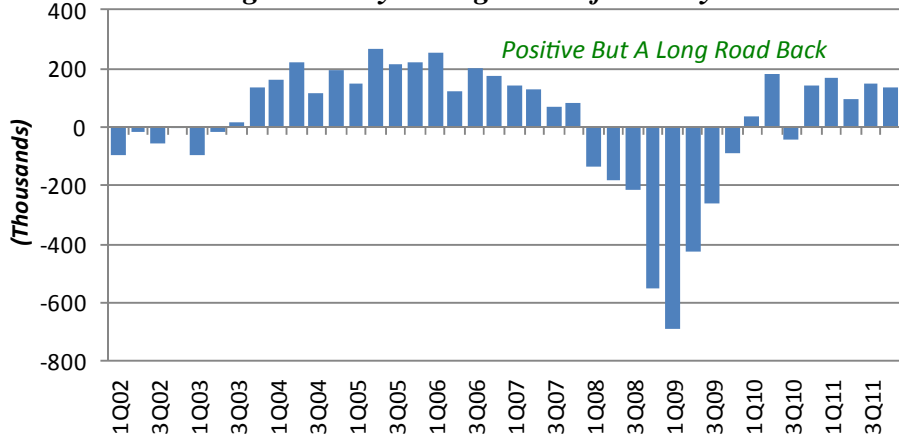
	12/31/10	9/30/11	12/31/11	Qtr Change	12-Month Change
3 Month T-Bills	0.1	0.1	0.0	-0.1	-0.1
5 Year Treasury	2.0	1.0	0.9	-0.1	-1.1
10 Year Treasury	3.4	2.0	2.0	—	-1.4
30 Year Treasury	4.3	2.9	2.9	—	-1.4
5 Year Corporate ('A')	3.2	2.7	2.8	+0.1	-0.4
10 Year Corporate ('A')	4.9	4.0	4.1	+0.1	-0.8
30 Year Fixed Rate Mortg.	4.8	4.0	4.0	—	-0.8

- Employment trends of local governments reflect the ongoing stress of that sector. In particular, local government employment continues to shrink. It has dropped by over 3% since the recovery has begun and is currently at its lowest level since November 2005 (see Graph #2).
- With home prices recently hitting a new low, housing is likely to remain a drag for the foreseeable future. Based on the Case-Shiller Index of 20 major metro areas, the index of home prices is currently at levels that existed in early 2003. One encouraging sign is that based on current selling rates, the supply of existing homes has fallen to 7 months – the lowest level in nearly 5 years (see Graph #3).
- The European crisis does not appear to lend itself to any short term resolution. Even if the debt crisis is managed off the headlines, the economic prospects for Europe are likely to remain dim for quite some time. This will impose some drag on the U. S. Economy.
- The political environment in the U. S. has been anything but settled during the past year and is likely to become even more volatile with the backdrop of the election year.

The Fed & Interest Rates: Twisting in the Wind

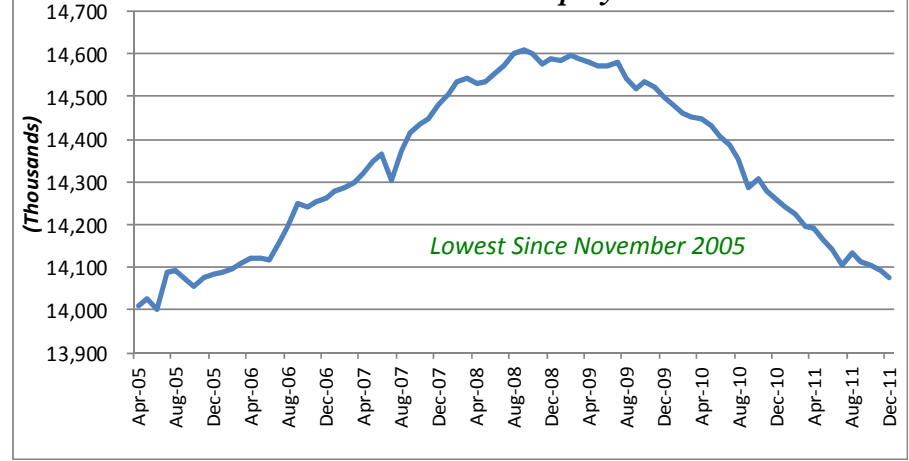
With the rating downgrade a distant memory, yields on Treasury securities remained mostly stable during the quarter at levels ranging from zero at the shortest maturities to less than 3 percent on 30-year Bonds. For the year, yields dropped substantially – especially considering that rates of 12 months ago were perceived to be extremely low. Long term Treasury Yields fell by nearly 1 ½ percent in 2011 as the Fed continues to apply full throttle to its monetary easing program. Based on actions and statements of the Fed, there is little to suggest any change in yields in the months immediately ahead. Credit markets were mostly stable during the quarter and appear to be sensitive to the European debt crisis. The overall economic climate and banking sector conditions, in particular, are likely to be influenced by how the Euro-crisis plays out. *The low level of yields coupled with the higher price sensitivity suggests to us that bond market returns in 2012 are likely to fall short of what has been experienced in the past several years.*

Graph 1 Average Monthly Change—Nonfarm Payrolls



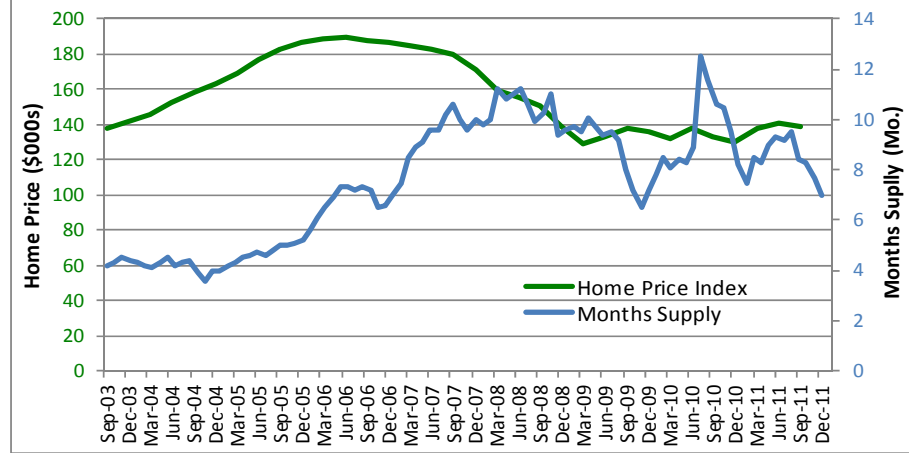
Source: U.S. Department of Labor & Statistics, Bloomberg

Graph 2 Local Government Employment



Source: U.S. Department of Commerce, Bloomberg

Graph 3 Housing: Months Supply vs. Home Price Index



Source: S&P Case-Shiller, Bloomberg

Employment Gains 2 1/2 Years After Recessions' End Table 3

Peak	Trough	Peak to Trough		Percent Regained
		Job Loss (000)	2 1/2 Year Gain (000)	
Dec-07	Jun-09	7,490	1,215	16%
Mar-01	Nov-01	1,599	460	29%
Jul-90	Mar-91	1,240	2,825	228%
Jul-81	Nov-82	2,824	8,522	302%
Jan-80	Jul-80	968	-851	-88%
Nov-73	Mar-75	1,260	3,243	257%

Source: Bloomberg