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“An economist’s guess is liable to be as good as anybody else’s.”

- Will Rogers

The world is flat...again Globalization has never been more evident than in 2011. Developments in one region – the natural disaster in Japan, “Arab Spring” uprisings, fiscal missteps in Europe, US policy-making – had instant ramifications on global supply chains and commodity, bond, and stock prices.

Although the S&P 500 ended the year roughly flat (ex dividends), the ride along the way was hardly boring. Clearly this year’s volatility has been a killer. Relative to high-grade bonds, where 10-year Treasury yields dropped from 3.30% to 1.90%, being long equities sometimes seemed insufferable. Worse, performance within sectors of the S&P diverged spectacularly, so there was plenty of room for active managers to get tripped up even if they were neutral to the market; Goldman Sachs reported that almost 72% of large cap core, 84% of large cap growth, and 62% of large cap value managers underperformed their respective benchmarks at year end.

Allocation matters Although resilient, the U.S. economy is not impervious to the nearly certain Eurozone recession. As such, a slowdown in U.S. growth is anticipated, although the U.S. has a trade *deficit, not a surplus*, with Europe, which has been steadily declining as a percentage of overall U.S. trade since 1990. In this environment, our asset allocation team has positioned our investment portfolios to reduce the effects of volatility over the next year. We continue to believe that asset classes that provide little correlation to equities and fixed income (such as international debt, commodities, and real estate) will help mitigate volatility going forward. While these investments may be risky on their own, when they are complimented with a diversified portfolio they can act as a ‘dampener’ during unsettling market conditions.

On our minds In Europe, it looks like the glass is half-full. Though full fiscal union has yet to be achieved, and a common government bond not yet issued, the process seems clearly in place to move in that direction. Markets, with the European Central Bank, seem to have gained the ability to discipline wayward politicians who attempt to backpedal from this direction – note how quickly the governments in Greece and Italy fell when their leaders suggested slowing down implementation of reform packages demanded by the markets and Germany.

While sovereign spreads on the PIIGS (Portugal, Italy, Ireland, Greece, and Spain) remain high – and are likely to for some time – it’s good to note that they’re stable at that level and not getting worse, and that it will take years, not months, to reset overall government funding rates at these high levels.

Helping People Manage Wealth to Shape Their Legacy

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Investment Management

Looking Back and Looking Ahead

Market Snapshot YTD through 12/31		
S&P 500	1,256	0.00%
DJIA	12,130	5.53%
10yr Treas	1.92%	-42.86%
Oil	\$ 100.40	8.83%
Gold	\$ 1,710	20.68%

On our doorstep Countering the risks in Europe is the continued constructive outlook for the U.S. economy, which has been resilient amidst recent uncertainty. Specifically, labor markets have shown recent improvement – seen not just through the 8.6% unemployment rate (falling from 9%), but also through jobless claims and other measures of employment.

Profit margins are the key reason earnings have rebounded so quickly in the recent cycle. Net margins for the S&P 500 hit a low of 5.9% in 2009. By 3Q 2010, margins had already returned to the previous 2Q 2007 peak of 8.3%. During the past year, margins have continued to rise and now stand at an all-time high of 9.9%. Also, S&P 500 non-financial firms still hold more than \$1.1 trillion in aggregate cash balances. The cash/asset ratio for S&P 500 non-financials has surged to an all-time high of 11% on the back of record net profit margins.

On our radar To be clear, the road ahead is indeed likely to be rocky, not smooth. The very nature of the process for resolving Europe's troubles – a public negotiation among sovereign states that lay out extreme positions in the hopes of a middle ground that is more palatable for them – leaves plenty of room for major market mood swings. Overlay on this the divisive rhetoric likely to accompany next year's **presidential election**, and you have a recipe for plenty of up-and-down vertical movement. Historical patterns in election years show returns in the fourth year of a presidential cycle when a Democrat is in the White House is 14%; when the current party wins, the return is 16%; when a Republican wins, the return is 16%; and when the party changes from Democrat to Republican, the return is 13%

As of this writing, weekly **jobless claims** are well below the 400,000 level. Also, the Employment Trends Index rose in November by the most in nine months, reaching its highest level since September 2008. This sustained pickup suggests some acceleration in job growth in the beginning of 2012. Goldman Sachs reported that due to a slower pace of growth in commodity prices, there are diminishing **inflation** pressures across all of the major components – goods, shelter, services, food, and energy.

Apple matters This year marked the passing of Apple icon Steve Jobs, and it's interesting to reflect on the impact that Apple has had on the technology world. AAPL accounts for 16% of the Information Technology sector's market cap, generates 18% of its earnings, and contributes a significant portion of the sector's growth. Information Technology margins are 100 basis points lower when AAPL is removed (16.5% vs. 15.6%). AAPL's impact on the technology sector becomes clear when 2011 results are viewed with and without the company. Year-over-year sales for the Tech sector equal 12% (compared with 8% excluding AAPL), margins expand by 76 basis points (compared with 28 basis points without AAPL) and bottom-line earnings-per-share growth is 18% (compared with 10% excluding AAPL).

Advisors matter A recent study by benefit consultant Aon Hewitt, looking at the 401(k) returns of 425,000 savers from 2006-2010, found that the median annual return of those who got professional advice was almost 3% higher than the return for those who invested on their own, even taking fees into account. Why? Do-it-yourselfers are more likely to invest too timidly or too aggressively and often at the wrong times.

So how will all of this affect your portfolio?
Ask your Area Wealth Advisor for their thoughts!

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