Quarterly Market Update

December 31, 2010

In spite of unemployment rates climbing to 9.8%, the S&P 500 gained more than 10% during the quarter, building on a similar increase during the third calendar quarter. Was it the Republican election success? Was it the implementation of the Federal Reserve's Quantitative Easing II (QE2)? Was it a flight to safer U.S. investments after Ireland's financial system needed to be bailed out? Was it the extension of the Bush tax rates? Or was it "all" or "none of the above?" The correct answer is, "none of the above."

Between September 30 and November 2nd the S&P 500 gained 5% and from then until December 31 it gained another 5%. It is hard to attribute the quarter's gain to market ebullience around Election Day when the pattern of price movement throughout the quarter made Election Day look like any other trading day.

The Federal Reserve's renewed program (QE2), of buying US Treasury Bonds to provide liquidity to the financial system, was seen by professional investors as a signal that the central bank would do its part to encourage economic growth. The presumed effect was that bond yields would decline and remain low, making equities more attractive, and that would result in stocks appreciating. For the six weeks from August 27th until October 8th, the time period from the announcement of considering QE2 to the date of the lowest yield on the US Treasury 10 year Note, yields did decline from 2.65% to 2.33%. Stocks likewise rose during this same time period, by nearly 10%. From October 8th until December 31st, the yield on the US Treasury 10 year Note increased from 2.33% to 3.31%. Ordinarily, rising yields would not support a rising stock market, yet the S&P 500 increased by nearly 8% over this time span. At most, QE2 played a minor supporting role in the 10% rise in the S&P 500 during the quarter.

It is possible to attribute some of the S&P 500's gain during the quarter to the Irish bailout. Investors had already seen how the European Central Bank rescued the troubled Greek economy, and appeared willing to help Ireland's economy as well. Since there was almost no American banking exposure to Ireland's troubled banking system, investors likely concluded that the impact on American Securities Markets would last only a day or two.

Not extending the tax cuts would have had a substantial negative impact on the stock market, but by mid-November it appeared that market participants anticipated, correctly, that the current tax structure would continue for two more years. It is possible to attribute the good quarterly results to that anticipation and subsequent tax extension. However, the case does not appear to be strong, based on relatively minor money flows out of tax-exempt, fixed income mutual funds and into common stock mutual funds during the quarter.

In fact, the most likely cause of the market's sustained good performance throughout the fourth quarter was that the overall pace of the economic recovery picked up just enough to improve consumer confidence. Corporate profits for the fourth quarter and their prospects for 2011 will likely be very good. This forecast will lead to investors remaining confident that higher stock prices will prevail in 2011.

Looking forward to the end of 2011, we anticipate another positive year for equity markets and a decidedly inferior one for fixed income markets. Our biggest concern about this forecast relates to a recent survey of employees of large companies. Fully 70% of them responded that if they could get a new job that was comparable to their current one, they would take it. Many companies have achieved their productivity gains by piling extra work on employees. This survey indicates that a better job market may produce a great deal of unwanted employee turnover which could affect corporate performance. We hope companies heed the warning inherent in this survey and take steps to assure continuity among their employees.

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