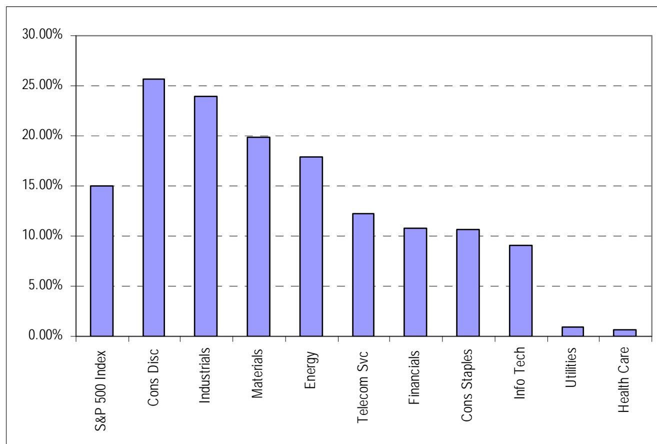
QUARTERLY REVIEW AND OUTLOOK
FOURTH QUARTER, 2010

A strong fourth quarter rally turned an okay year for US stocks into a good one. The US stock market's surge in October and December resulted in gains for the S&P 500 Index of 10.76% for the quarter and 15.06% for the year. Smaller company stocks, as represented by the Russell 2000 Index, generated returns of 16.25% and 26.85% for the quarter and full year, respectively.

Within the US large-cap market, sector performance ranged from 25.7% for the consumer discretionary sector to 0.7% for health care stocks as a group (Chart 1).

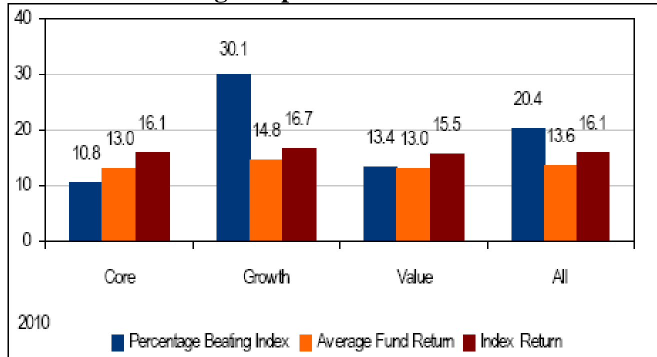
Chart 1: 2010 Sector Returns



Source: Standard and Poor's

While US stocks did well, only 1 in 5 large-cap mutual funds outperformed the Russell 1000 Index in 2010 (Chart 2).

Chart 2: 2010 Large-Cap Mutual Fund Performance

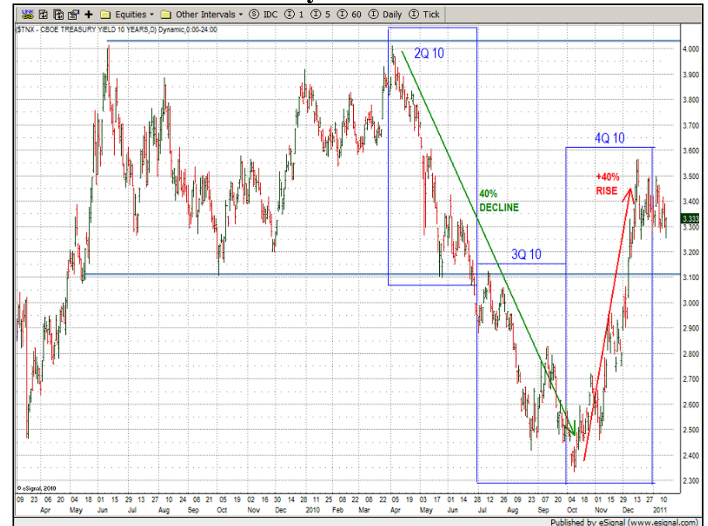


Source: Bank of America Merrill Lynch

Stock market performance outside the US was more of a mixed bag with the MSCI EAFE Index of developed foreign markets returning 6.61% for the quarter and 7.75% for the year. Interestingly, the stock markets of China and Brazil – who have been leaders in the global recovery – generated returns of only 4.63% (MSCI China Index) and 6.54% (MSCI Brazil Index) for the year. The divergent action of these two markets and US stocks runs counter to the divergent fortunes of the underlying economies – a reminder that stocks and economies are not one and the same.

Bond yields rose in the fourth-quarter from the extremely low levels of late-September/early-October (Chart 3).

Chart 3: 10-Year Treasury Yield



Source: eSignal

This pressured bond market returns as most sectors of the fixed-income markets posted negative returns for the quarter (Table 1).

Table 1: Bond Market Returns

Index	Dec-10	4th Quarter, 2010	Last 6 months	Last 12 months	Last 3 years	Last 5 years
Barclays Capital U.S. Aggregate Bond Index	(1.08)	(1.30)	1.15	6.54	5.90	5.80
Barclays Capital U.S. 1-3 Year Treasury Bond Index	(0.19)	(0.15)	0.48	2.40	3.26	4.19
Barclays Capital U.S. 10-20 Year Treasury Bond Idx	(3.83)	(6.64)	(1.49)	9.70	6.45	6.21
Barclays Capital U.S. 20+ Year Treasury Bond Index	(3.68)	(9.32)	(4.80)	9.38	4.76	5.03
Barclays Capital U.S. TIPS Index (Series-L)	(1.55)	(0.65)	1.82	6.31	4.97	5.33
iBoxx $ Liquid Investment Grade Index	(1.26)	(2.34)	3.19	9.37	7.59	6.14
iBoxx $ Liquid High Yield Index	2.11	3.01	9.44	12.58	7.38	
S&P National AMT-Free Municipal Bond Index	(4.62)	(1.13)	2.31	2.31	3.71	

Source: iShares.com

With regard to the relationship between stock prices and bond yields, last quarter we wrote:

> *Stock prices and bond yields tend to be positively correlated. At this time, however, Treasury bond yields are closing in on all time lows, and stocks are closing in on or making new recovery highs. It is unlikely that the relationship between stock*

prices and bond yields has been repealed. Therefore, we must be prepared for the convergence of the two at some point in the future…and bond yields tend to lead stock prices.

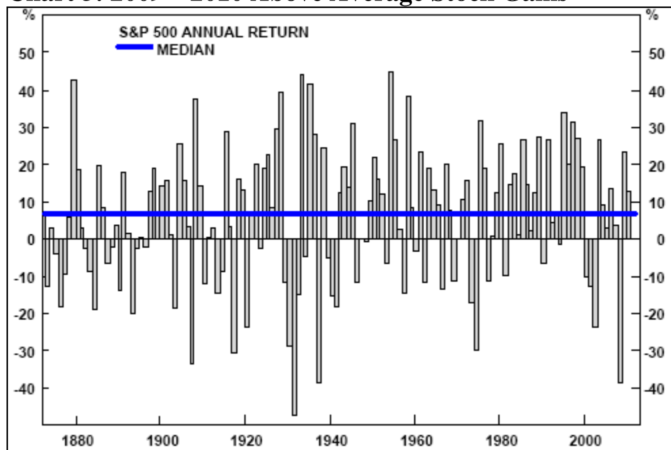
As illustrated in Chart 4 below, there has been *some* convergence in stock prices and bond yields over the last three-months, but this has been due solely to rising bond yields.

Chart 4: S&P 500 and 10-yr Treasury YIELD (last 4-yrs)

Source: bigcharts.com

2010's gains topped the market's median annual return of 7% (Chart 5).

Chart 5: 2009 – 2010 Above Average Stock Gains



Source: BCA Research

Returns for the year also rank highly in the context of post-recession stock market recoveries.
Table 2 illustrates the returns generated by the S&P 500 Index in the first, second and third years following a bottom in the equity market. The return on the Index during the first year of this recovery (March 2009 – February 2010) was among the best first-year performances ever, as was the first 10 months of the second-year, ended December 31. In other words, the stock market is on track to record two consecutive years of significantly above average post-recession returns.

Fortunately, there is historical precedent for three consecutive years of post-recession gains. Higher second year returns, however, tend to be associated with lower third-year returns (and vice versa). Nevertheless, the tailwinds of an improving economic backdrop, a very accommodative Federal Reserve Board, reasonable valuation and strong corporate balance sheets are supportive of the stock market.

Table 2: S&P 500 12-Mo. Post-Recession Returns

	PRICE RETURN		
MARKET TROUGH	First Year	Second Year	Third Year
August, 1953	35.2	41.0	5.6
November, 1957	32.6	10.4	(5.7)
October, 1960	26.5	(17.3)	28.8
June, 1970	37.1	7.5	(2.7)
September, 1974	32.0	25.5	(8.3)
July, 1982	51.8	(7.3)	26.7
October, 1990	29.1	6.7	1.7
February, 2003	36.1	5.1	6.4
February, 2009	50.3	12.8*	
Median	33.9	7.1	6.0
Mean	35.1	8.9	7.8
**10 Months Ended December 31, 2010*			

Source: BCA Research

The recent strength in stock prices and the gradual improvement in the economy should not, however, lull anyone into a state of complacency. Though the economy is currently improving at the margin and could exhibit stronger growth in 2011, longer-term risks remain. In fact, the story is not very different from the one we've been writing about for the last year-or-so with regard to the structural headwinds of high debt levels (both public and private), a weak labor market and a potential sovereign debt crisis.

Technically, stocks look stretched following the four-month rally into year-end. At present, bullishness toward the stock market is pervasive as the government has succeeded in suppressing asset volatility with new stimulus. A steady inflow of capital has supported a low volatility climb in share prices since the end of August. This has fostered a momentum chasing mood.

Measures of investor sentiment are at levels that have consistently preceded draw-downs in the past. The lags between elevated sentiment and corrections vary significantly, however, and sentiment should not be viewed in isolation. On this score, measures of technical conditions are also "overbought". One example is that according to Sentimentrader.com, the S&P 500 has now gone 92 days without closing below its 50-day moving average. That has only happened 17 times since 1928. But what is really amazing is that over the past 30 days, we haven't closed below the 10-day moving average even once. That has not happened in the last 82 years of market history.

Positive economic surprises have been an important contributor to this momentum dynamic. However, the combination of elevated equity market and economic sentiment provides a stronger warning signal for the broad

market – especially as company insiders stepped up selling in the final months of 2010.

Additionally, the VIX Index of equity market option volatility has been sitting at levels that indicate a high degree of complacency. While these conditions can persist for a long period, the recently increasing bond market volatility may be foreshadowing a period of elevated stock market volatility.

While the pre-conditions for a corrective phase are accumulating, the timing is difficult to predict. Our strategy in this environment is to maintain a conservative bias in our clients' portfolios as we try to balance the positive short-run outlook and market performance with a realistic assessment and respect for what potentially lies ahead. We find ourselves faced with the dilemma of investing based on short-term and largely artificial conditions while looking out for signs of the next potential crisis.

MUNICIPAL BONDS

Chart 6: Vanguard Total Bond Market Index Fund and Vanguard Intermediate-Term Municipal Bond Fund

Source: bigcharts.com

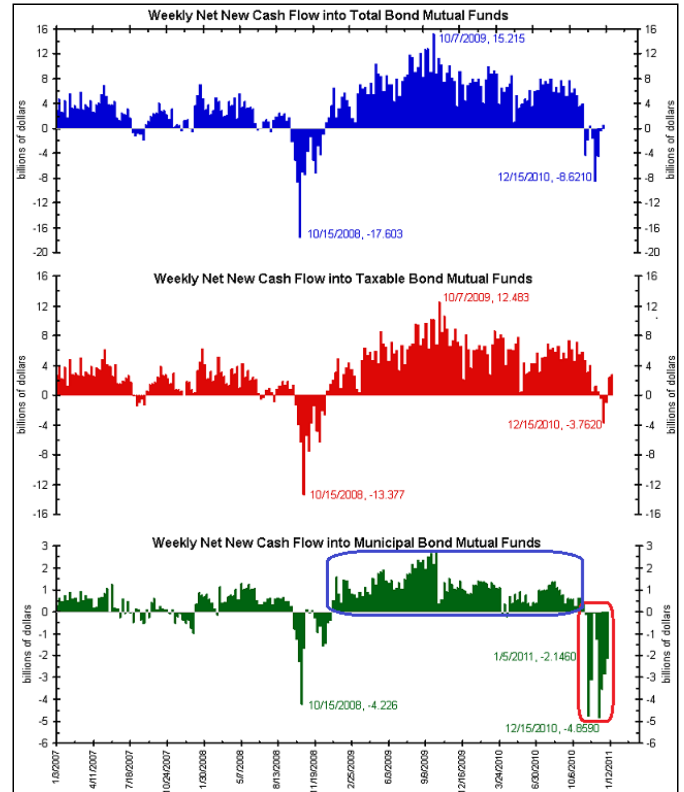
The municipal bond market has under-performed the broad taxable bond market recently (chart 6) and has received a lot of coverage by the media. In particular, Meredith Whitney's (an ace equity analyst who foresaw the problems at US banks ahead of the financial crisis) appearance on *60 Minutes* on Sunday, December 19, where she predicted "hundreds of billions" in municipal bond defaults in 2011 has received a lot of attention (Note: the one-year default record, set in 2008, is $8.2 billion). Additionally, Warren Buffett, hedge fund manager Jim Chanos and others (mostly individuals from outside the municipal finance sector) have warned of difficulties ahead.

This is obviously an important issue. Municipal bonds – either individually or in mutual funds – are an important component in our clients' taxable portfolios. While it is impossible to forecast with certainty how this situation will play out, below is our assessment at this point.

First of all, it's important to understand that the municipal bond market is susceptible to large volatility swings. It is driven by the decisions of millions of American taxpayers and is comprised of nearly 100,000 separate issues totaling almost $3 trillion. The reported prices of bonds are estimated by mathematical formulas from limited actual transactions since only a fraction of issues trade daily. This sector is not like the stock market; pricing is not transparent.

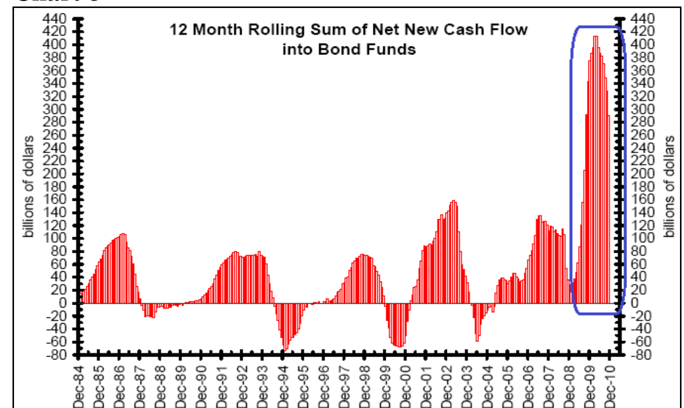
Municipal bond mutual funds have experienced rather large redemptions recently (chart 7, bottom pane, red circle). This follows a period of larger than normal cash flow INTO municipal and most other types of bond funds (chart 7, bottom pane, blue circle and chart 8, blue circle) as investors moved out the risk spectrum due to near-zero percent short-term interest rates.

Chart 7



Source: Investment Co. Institute & Bianco Research, LLC

Chart 8



Source: Investment Co. Institute & Bianco Research, LLC

In Muniland, mutual fund redemptions have driven fund managers to liquidate municipal bonds into a market with falling prices. This forced selling drives published prices of many bonds down rather dramatically even though only a few trades may actually occur. This can result in emotional panic selling and become something of a self-fulfilling prophesy. Additionally, the media hype that surrounds situations like this tends to exacerbate the situation.

While the increased liquidations have contributed to the recent decline in the municipal bond market, so too have higher interest rates in general and the decision by congress not to extend the Build America Bonds (BABs – a type of taxable municipal bond whereby the issuer receives a 35% subsidy from the federal government of the interest it pays bondholders) program which has led to higher tax-free issuance (supply). These additional factors aside, the main issue on the mind of investors is credit quality – i.e. are we really going to experience the level of defaults that some analysts are predicting?

Our honest assessment at this point – based on our own analysis and experience, and the analysis of a number of leading experts – is that while there will likely be a rising number of municipal bond defaults in the years ahead, the level of fear in the market is not justified. Further, we believe the recent decline in municipal bond prices has resulted in good value *relative* to other sectors of the fixed-income market.

As evidence of this, Bill Gross, who manages the world's biggest bond fund at PIMCO, recently invested at least $14 million of his own money in several municipal bond funds. Since there is possibly no better long-, or short-term bond investor than Gross, we believe his view of the sector deserves attention and given his personal investment, he clearly sees value in the sector.

Also challenging the dire outlook for the municipal bond market are the three main bond rating agencies: Standard and Poor's (S&P), Moody's Investors Service (Moody's), and Fitch Ratings – none of which believes US state and local governments are facing a debt crisis where we are going to see widespread defaults. According to S&P:

- State governments' debt service payments as a percent of revenue average just 4%. That compares to 15% for sovereign governments rated AAA by S&P.
- No state or local government defaulted on any *rated* debt in 2009 (in the depths of the recession that began in 2008).
- In 2010, there were three defaults by local issuers – none of which had investment-grade ratings.

According to Moody's, only 54 of 18,400 rated municipal bonds defaulted from 1970 to 2009.

One problem municipal sector defenders currently face is the the recent history with housing credit and European Sovereign debt. Think of it as a form of guilt by association. Four or five years ago, the likes of Robert Shiller and Nouriel Roubini dared to say housing was overdone and vulnerable to an epic collapse. The housing defenders dismissed them as being foolish by using historical statistics, detailing covenants and what they thought was reasonable logic. But we had a massive and painful housing bust anyway. This is also true regarding the sovereign debt crisis in Europe. In 2009, anyone who said that the 10-year debt yield of Greece would trade 12%, Ireland 8% and Spain 5% while Germany was under 3% would not have been taken seriously. No one obviously did say that because of the Stability Pact, the role of ECB and the sophistication of this market. Well guess what, it happened anyway.

So, do we think there will be waves of municipal defaults? No, not at this point. But given the recent history of housing going bust and Sovereign debt problems in Europe, many are hesitant to accept the muni defenders arguments. As long as the US is running a huge budget deficit and states struggle with their finances, the story of widespread municipal bond defaults will likely stay with us. And we will continue to do our best to evaluate the environment.

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