m a r k e t c o m m e n t a r y

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In the end, for investors in large capitalization U.S. stocks, nothing much changed in 2011. For the year, the S&P 500 rose by 2.1% on a total return basis. This was below its long-term trend, but acceptable in the current low interest rate environment. However, the modest annual return for the S&P does not tell the full story of 2011. In a notable change of relative fortune, the small and mid capitalization indices were weaker for the year, falling by 4.2% and 1.6% respectively. Globally there was much more pain, with EAFE (developed foreign markets) declining by 12.1% and Emerging Markets falling by 18.4%. It is in the extreme weakness for the international markets and the underperformance of the smaller capitalization indices that we find the real story for the year.

2011 was a year in which investors retreated from risk. In the bond market this meant better returns as interest rates fell. Treasuries were the top performers, with municipal and corporate bonds out-performing equities as well. In equities it meant the shelter of larger, more stable companies that paid attractive and growing dividends. The source of the risk aversion was instability in governments – most notably in Europe – caused by the sovereign debt crisis, but also in the U.S., as Congress and the Administration fought over the debt ceiling and fiscal stimulus. The almost monthly crisis in Europe, beginning with Greece and moving on to Spain and Italy, that raised fears of another global fiscal crisis, caused investors to look for stability wherever they could. Periodic optimism about solutions to the problems led also to significant volatility during the year. In order to produce its annual return of 2.1%, the S&P had to rally by 11.8 % in the fourth quarter. These violent moves in the market fed the risk aversion of investors and further contributed to the character of the returns of the year.

We do not anticipate much change to the nature or pattern of volatile returns as we enter 2012. The crisis in Europe continues. A massive need to refinance debt in the first quarter, elections in Greece and France, and falling economic activity should keep the markets in turmoil. The European Central Bank (ECB) has managed to provide financing for the banks, but politics and predilection have kept it from stabilizing the market for sovereign credits. In the U.S., our own political spats will continue. The two-month extension of unemployment benefits and payroll tax cuts, along with the need to expand the debt ceiling under the terms of the August compromise, insures another period of market-moving debate in the first quarter. Economic activity in the U.S. has been improving, but a rapid slowdown in Europe, a stronger dollar, and slowing in Asia, may negatively impact both activity and corporate profits in the coming quarter.

On the other hand, good things could happen in the coming months. Governments in Europe and/or the U.S. could find common ground and provide confidence to skeptical investors. In the emerging markets, central banks are beginning to react to weakness in Europe and their own economies by easing monetary conditions. If continued, this would provide an important boost to global economic activity and markets. The modest recovery in the U.S. economy could improve if housing bottoms out and employment numbers creep higher.

On balance, we think it best to prepare for a market that will want to minimize risk by emphasizing stocks that did well in the latter half of 2011; larger capitalization companies with the ability to both pay and grow their dividends.