

INVESTMENT COMMENTARY

A PUBLICATION OF LARRY THOMPSON & ASSOCIATES, INC.

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Volume 14, Issue 4

4th Quarter 2010

Index	Quarter	Year to Date	Trailing 1 Year	Trailing 3 Years	Trailing 5 Years	Trailing 10 Years
<u>Domestic Equity</u>						
S&P 500	10.76	15.05	15.05	-2.86	2.30	1.41
Russell 1000 (Large Cap)	11.19	16.10	16.10	-2.37	2.59	1.83
Russell MidCap	13.07	25.48	25.48	1.05	4.66	6.54
Russell 2000 (Small Cap)	16.25	26.85	26.85	2.22	4.47	6.33
<u>International Equity</u>						
MSCI World ex US (Developed)	7.16	8.95	8.95	-6.33	3.05	3.98
MSCI Emerging Markets	7.34	18.88	18.88	-0.32	12.78	15.89
<u>Real Estate</u>						
FTSE/Nareit Equity REITs (public)	7.44	27.96	27.96	0.66	3.04	10.77
<u>Domestic Fixed Income</u>						
Barclays U.S. Aggregate	-1.30	6.54	6.54	5.91	5.80	5.84
Barclays U.S. TIPS	-0.67	6.29	6.29	4.96	5.34	6.91
Barclays Municipal	-3.66	4.04	4.04	5.08	4.84	5.15
Barclays High Yield	3.22	15.11	15.11	10.38	8.92	8.89
Citigroup 3-Month T-Bill	0.03	0.14	0.14	0.49	2.14	2.18
<u>International Fixed Income</u>						
Citigroup Non-\$ World Gov't Bond	-1.45	5.21	5.21	6.54	7.59	7.42
<u>Commodities</u>						
UBS/Dow Jones Commodity Index	15.79	16.83	16.83	-3.67	1.18	5.84

The fourth quarter of 2010 was an unusual one, at least for the world's financial markets. Investors turned their attention away from the struggling economy and high unemployment and chose to focus more on global credit crises and the bond markets. It is rare to see panic in the bond markets, but even more rare for worried bond investors to embrace equities. On the one hand, investors are saying that government finances are so poor that they will struggle to pay their debts, while on the other, believing the economy is strong enough to justify buying equities, typically a far riskier investment.

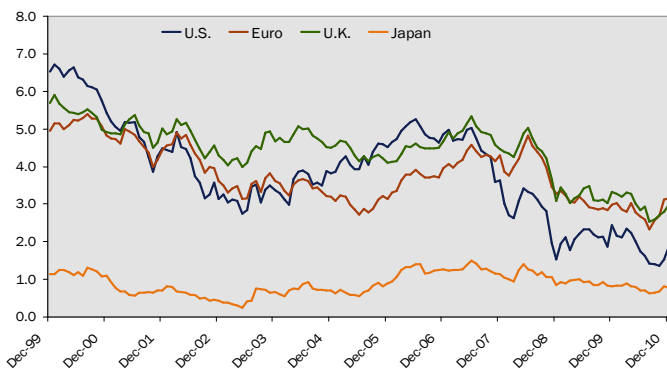
2010 was a year that reminded us much of 2004, another year with double digit positive equity market returns, but also a year that gave us stories of a jobless recovery and slow, below average economic growth. Much like 2010, 2004 followed a very strong equity market in 2003 as the economy began its recovery from the last recession. 2005 turned out to be a below average year for the equity market and some are anticipating a similar result in 2011.

Returns of Russell 1000

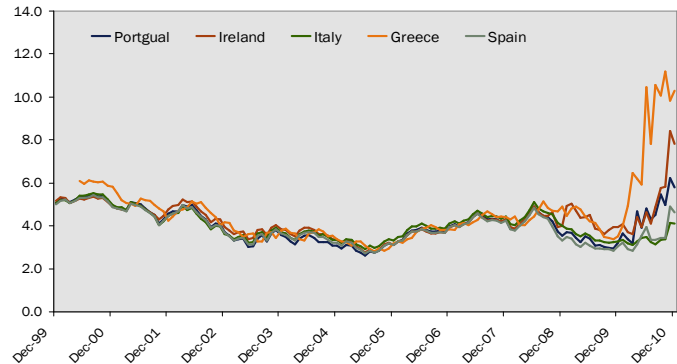
2003	29.9%	2009	28.4%
2004	11.4%	2010	16.1%
2005	6.3%	2011	???

While the equity markets have been doing very well, clouds appear to be gathering in the bond market. Bond yields around the developed world have risen during the past few months as investors' interest in bonds has waned. In the U.S., the greatest losses have been in the municipal bond market where stories began to appear about the struggle states and municipalities now face to balance their books and pay for pension and healthcare benefits promised to public sector employees. Globally, Greek, Irish, and Portuguese investors have suffered the most, but government bond prices have fallen in the U.S., German, British, and Japanese markets. Have investors lost confidence in developed world bond markets, or is there something else driving

Government Bond Yields



Government Bond Yields - PIIGS



these markets?

As most readers know, bond yields are inversely related to bond prices. As investors sell bonds, yields rise (not rates-of-return), just as when investors buy bonds, yields fall. In December of 2008 – at the height of the financial crisis – investors were selling equities and buying large quantities of U.S. Treasuries. This demand drove yields on the 10-Year Treasury to all time lows, and even resulted in negative yields on some short-term Treasuries. While yields remain low, investors are clearly showing less interest in owning bonds today than during recent quarters. The interesting question is “Why?”.

The most pessimistic camp believes that the United States’ overwhelming amount of debt, along with additional borrowing, will eventually destroy our country’s credit. Even the slightest perception by lenders (bond buyers) that our country’s debt rating was less than perfect would be catastrophic to our bond markets. Yields would skyrocket as bond prices would crumble. Readers need to look no further than Greece or Ireland to see this scenario first hand. This camp is likely buying gold right now. Although we are troubled by our nation’s growing debt burden and respect the possibility, we assign a low probability to this scenario—at least in the near term—and do not believe that this is responsible for the recent softness in the U.S. Treasury markets.

Other investors believe that the government's stimulus will ultimately lead to high inflation. Should this materialize, we would likely see hikes in the Fed funds rate as well as higher rates on longer term bonds. While we see this as a higher probability scenario, we do not see rampant inflation in the near term. Yes, our economy appears to be recovering, but growth is fairly modest. Yes, the government has injected a massive amount of money into the system, but the amount of this money that has actually flowed through to our economy has been relatively small. While inflation is unlikely to be a significant problem this year, there is little doubt that some investors are shunning bonds as a result of their inflationary concerns and what this would likely mean for the bond markets.

We believe that the most likely reason behind the recent strength in the equity markets and the softness in the debt markets is the result of investors' belief that equities simply represent better values. While we would like to see evidence of additional economic strength, it is not uncommon for equity markets to recover ahead of economic growth visibility. In our view, the case for a strong bond market is low. A severe downturn in the economy and/or some unforeseen "event" sending market participants out of equities and to the perceived safety of the bond market would have to occur.

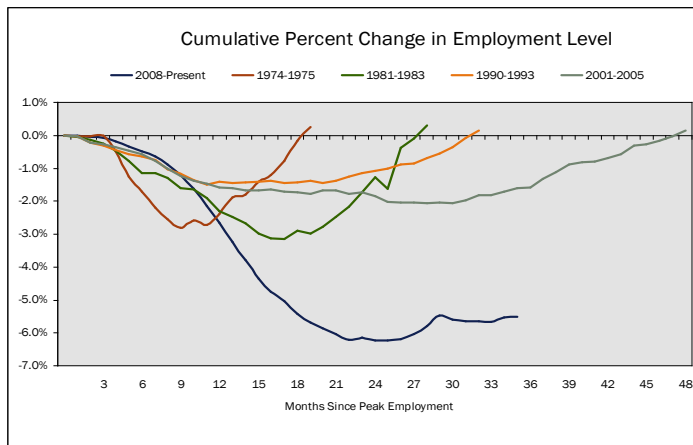
The Federal Reserve's announcement in November regarding the latest round of quantitative easing provides some evidence of the investor psychology surrounding the bond market as well as Government action. Following the announcement, bond prices began to fall as investors sold their bonds. In theory, this was the exact opposite reaction the Fed wanted, as the idea behind quantitative easing is to lower interest rates by creating extra demand for bonds. Normally, a move such as this would have been beneficial to bond holders. However, many bond investors interpreted the move as one that would lead to inflation, eroding the value of their bond income. Accordingly, they chose to sell their bond holdings.

In reality, the Fed was probably pleased with the result of their announcement as the equity market was a significant beneficiary of the bond market selling. One of the Fed's goals is to improve the economy and whether it means allowing banks to offer loans at low interest rates via quantitative easing, or through individuals building wealth through more valuable stock holdings, their mission was accomplished.

European bond prices have also been falling. While there are notable exceptions where investors are shedding the bonds of Greece, Ireland and other known problem areas, we believe that most of the bond market downturn of late is the result of an increased appetite for equities—just like in the U.S. markets.

European governments have taken a different approach to their finances than the U.S. While we continue to attempt to stimulate our economy through low interest rates, low taxes, and the "wealth affect" (and promising to pay for it all in the future), Europe has opted to tackle their rising debt levels first, hoping that lower debt will free government funds to stimulate the economy at a later date. Europe will suffer some short term pain, but it should be more financially sound in the future and better equipped to grow than it is today. Hopefully, the U.S. will be economically stronger sooner, which will allow us the ability to pay our debts later. In both cases, the equity markets have responded positively.

The U.S. government and Federal Reserve have been spending much time discussing their desires to create jobs. It has now been 36 months since U.S. employment levels peaked (December 2007) and it will likely be years before we get back to that level, if ever. The chart on the next page shows the extent of the job losses during this time compared to other recent recessions. The current employment situation is far worse than anything we have seen in the past few decades. More worrying is the fact that each recession has required a greater time to get back to peak employment levels. After the 2001 recession, it took four years to earn



back the lost jobs, and we had the benefit of a booming housing industry to provide employment. So far, 36 months since the peak, we have not seen a significant change in the employment level. In our opinion, we may not get back to the previous peak employment levels. A likely scenario is that we have a new level of structural unemployment in our country, one that is similar to what Europe has had for the past few decades. In simple terms, our country has a mismatch between our workers skills and the economy's needs. Structural unemployment is very difficult to overcome as it typically requires workers to learn new skills to compete for the available jobs. We believe that the U.S. will have sustained high unemployment rates in the coming years, despite the efforts of our government.

As we look into 2011, we believe that equity markets will continue to move higher, while debt markets will do worse than they have in the past few years. Consumers and investors appear to be more confident today than at any time since the beginning of the crisis in 2008 and we believe the equity markets will benefit. A further boost to the equity markets may come in the form of unexpected consumer spending. Recent data suggests that Christmas spending was robust this year, at least early in the season, and there is hope that the consumer will begin to increase its spending and create stronger economic growth and equity prices.

Despite our somewhat optimistic view of the equity markets, we remain mindful that our

economy is not free from a number of potentially serious problems. Our debt burden is growing by the minute and there seems to be no end in sight. Unemployment teeters at 10% and may stay close to that level for many years. The problems in residential real estate not only have crushed the industry proper, but also wiped away billions of dollars of equity and limited the mobility of underwater occupants.

We continue to recommend to our clients that they pursue a broad diversification strategy. While we prefer public equity exposure across all capitalization ranges, domestically and internationally, and favor a meaningful allocation to emerging economies, investors should realize that diversification across public equities does not typically offer much in the way of risk mitigation during market downturns. When appropriate, we also suggest allocations to non-public equity strategies, which may include commodities, real estate, natural resources and certain hedging strategies. And, despite our muted outlook for fixed-income, bonds are typically a great diversifier and can serve an investor well during severe equity market dislocations. As always, we welcome readers' thoughts and questions.

We wish everyone a happy and prosperous 2011!