

January 2011

Although it ended well, 2010 proved to be a bumpy ride for investors. After a strong start the first few months, the stock market dipped in the summer as the European debt crisis and fears of a double dip recession intensified. By year end, however, the S & P 500 index had bounced back more than 22% from its July low to post a strong annual gain of 15%. Since the recession lows of March 2009, the index is up over 90%. Emerging markets and commodities were standouts this year, U.S. stocks beat developed foreign stocks, small and mid cap equities outperformed large cap equities, and growth stocks lead value stocks.

The beginning of a new year brings with it a new season of prognostication. Predictions are rampant and include everything from which team will win the Super Bowl to which movie will win Best Picture to what policies will emerge from Washington. The big one that everyone wants answered, of course, is where the financial markets will be one year from now.

As expected, the 2011 forecasts vary widely. There are reasons for optimism as the U.S. economy is growing, albeit slowly. Corporate profits are up, the unemployment rate has stabilized, and consumer spending has started to increase. The Fed has adopted a stimulative monetary policy as have central banks in the developed world and because of the weak housing market, high unemployment rate, and potential state budget issues, it is likely to continue this accommodative policy. Recent fiscal policies have also been stimulative as tax cuts and unemployment benefits were extended, payroll taxes were cut temporarily, and business investment expensing was accelerated. There is still a lot of money on the sidelines, and investors are beginning to ease back into risky assets. All of this should be good for the stock market.

On the other hand, despite the fact that the economy is showing signs of improvement, it remains fragile and we are clearly not out of the woods. The market has run up a lot in a short period and much of the good news may already be priced in. High personal debt levels, elevated unemployment and a continued weak housing market all create consumer spending headwinds. The Federal government's debt level is unsustainable and eventually spending cuts or tax increases will be needed to bring it under control. State and municipal governments are highly stressed, and the sovereign debt crisis in Europe remains a concern. Some of the emerging markets are tightening their monetary and fiscal policies. All of these factors point to challenging times ahead for the market. A short-term pullback of some kind would not be a surprise. So which will it be?

A recent article in *The New York Times* noted that the consensus of Wall Street strategists in January 2008 was that corporate profits would extend the stock

market's long-term rally, raising the S & P 500 index by more than 12 percent, plus dividends. As we remember all too clearly, the market decreased by 37% that year, nothing like the rosy picture the so-called experts had forecast. This pattern of failed predictions has repeated itself year after year.

So what is the value of forecasts? The media loves them, they are exciting to read and watch on TV, and they allow us to wrap our arms around something concrete that then gives us reasons to move in a certain direction. Not only are there predictions based on what is currently going on in the world but there are also ones based on historical statistics. Going into 2011, who wouldn't want to know that in pre-election years the S & P 500 has gained an average of over 17% and has had no down years since 1945? It would be nice if the markets followed the forecasts; however, we all know that the world is filled with uncertainty. Another issue is that market performance depends not only on actual economic data but also, and to a great extent, on investor sentiment. It is easier to predict an earnings estimate for the S & P 500 for the coming year than to predict what price earnings multiple a volatile market will put on that estimate as investor psychology affects these valuations. Investors are definitely more optimistic now than they have been over the past two years but sometimes the big market increases occur before the herd mentality takes over.

History tells us that it is not worth putting too much faith in any one prediction. Remember that investing in the stock market should be done with a longer term view. Assets that you will need in the short term should not be subject to market volatility as returns are significantly affected by unpredictable events in any given month or year. Over the longer term, however, these bumps tend to smooth out.

The lesson we should learn from this is that we should not do anything rash based on the multitude of forecasts with which we are currently bombarded. Instead, use them as an opportunity to educate yourselves on reasons to be both optimistic and pessimistic and to understand why the markets are unpredictable and volatile in the short term. The new year is a good time to focus on your goals so that you remember why you are investing and make resolutions to get in shape financially. Once you have this knowledge, we can help you stay on track to reach these goals and help you make disciplined investment allocation choices in the face of uncertainty.

Of the many wonderful holiday wishes we received, I want to share with you one that particularly resonated with us. It came from the Girl Scouts of Eastern Pennsylvania, a non-profit organization on whose Investment Committee I serve. It said "Best wishes for a year filled with dreams, journeys and peace" and that is what I wish all of you.

