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2010
DECEMBER

Craig Cairns,
President

The Equity Market

Happy New Year!

The stock market was teetering in late August with the S&P 500 stock index down 4.9% and investors fearful that it would fall further. There was real worry that the United States would slip again into a recession as severe as 2008—the dreaded double dip. This was a far cry from the beginning of the year when consensus held that economic growth would continue to strengthen until the country was squarely on the road to recovery. Instead 2010 had not been going as anticipated by economists: economic growth was much slower than predicted, unemployment stubbornly refused to move downward from 10% and several countries in the European Union looked like they might go bankrupt.

The Federal Reserve Chairman Ben Bernanke felt that he had no choice except to do something dramatic and in a speech at Jackson Hole, Wyoming in August announced a second round of quantitative easing with the Fed potentially buying up to $600 billion of Treasuries. The goal would be two-fold: first to stimulate the economy by dumping dollars into the system and second to drive longer-term interest rates lower. Since about the time of the speech, the stock market rocketed upward bouncing more than 20% off the bottom until the end of the year as the fear of a double dip subsided.

The election results helped in November as investors will once again enjoy the gridlock of two-party rule. Regardless of how you feel personally about the election, the stock market has historically performed better when opposite parties control the Presidency and the Congress and is typically stronger under a Democratic President and a Republican Congress.

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Vince Russo,
Vice President, Director of Fixed Income Research

The Bond Market

4th Quarter Overview

By Vince Russo

Not a good way to end the year or usher in the New Year for Fixed Income Investments

After six consecutive quarters of positive performance, the bond market has hit a major speed bump. All of the major bond indices will most likely record the worst quarterly performance in quite some time. Based on the data below, as of this writing, the Barclays Intermediate Government/Credit Index (the benchmark index that we most closely monitor) will have experienced the worst quarter since the 2nd quarter of 2004 (-2.52%). That weak bond market performance coincided with (was a result of) the Federal Reserve Bank beginning a new cycle of monetary policy tightening in June of 2004. This quarter's negative performance was not due to any tightening of monetary policy. In fact, monetary policy is still in the easing phase.

Start Date: 9/30/2010 End Date: 12/27/2010

Index	Return for Period
Intermediate U.S. Government / Credit	-1.76%
U.S Treasury: Intermediate	-2.05%
U.S. MBS Agency Fixed Rate MBS	-0.12%
U.S. Agency: Intermediate	-0.88%
Intermediate: Corporate	-1.55%
Intermediate Utility	-1.83%
Invest. Grade: Industrial - Intermediate	-1.88%
Invest. Grade: Financial Institutions - Intermediate	-1.08%
U.S Treasury Inflation Notes: 5+ Years	-1.08%
Municipal Bond: 1-10 Yr Blend (1-12)	-1.89%

Source: Barclays Capital

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Happy New Year! *continued from page 1*

Bonds took it on the chin in the fourth quarter after two years of declining interest rates and price gains. Instead of driving down longer-term rates like planned, the prospects of economic growth resulting from the quantitative easing fueled inflation fears and drove up longer-term interest rates. The decrease in bond prices surprised some investors who had gotten used to price appreciation in addition to earning their coupon. Bonds fell well off their highs in the fourth quarter, but they still had a nice return as the Barclays US Govt/Credit Index earned 5.9% for 2010.

Heading into 2010, we believed that economic growth was going to be slower and choppier than the enthusiastic consensus and we positioned the portfolio accordingly by buying or holding stable stocks with growing earnings. We were right on the economy as actual economic growth missed the consensus estimates badly in the second and third quarters and the stock market floundered. What we did not get completely right was the type of stock that would perform best in 2010—aggressive, lower quality companies with little or no earnings growth even though the economy was not acting particularly healthy.

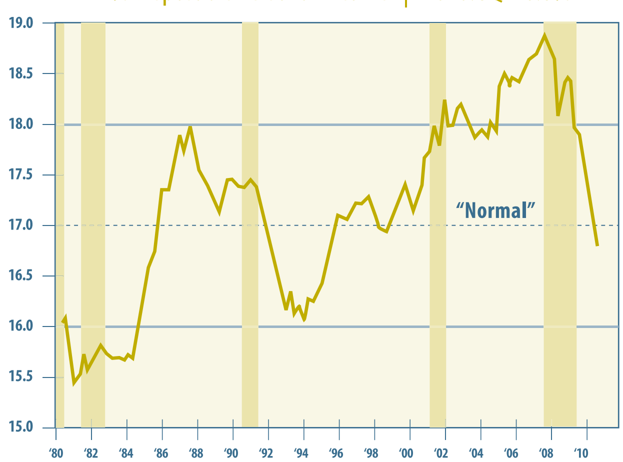
2011

We find ourselves more optimistic about the prospects for economic growth and the stock market than we were heading into 2010. We still have big concerns which we will discuss below, but the improving investor confidence which drove the stock market in the fourth quarter should allow the market to continue to eke out gains.

Quantitative easing continues to be positive for the stock market. The Fed began the quantitative easing by buying $60 billion worth of Treasuries over the past six weeks. Investors shrugged off worries of a double dip recession, the stock market continued to rise and longer-term interest rates rose on higher inflation concerns driven by the prospects of economic growth.

The consumer may have begun to rally. In addition to improving savings rates since 2008, consumers have been improving their personal balance sheets. The economic forecaster at ISI report that after a few years above normal, U.S. consumers' financial obligations as a percentage of disposable personal income has come down below the Normal Range of 17%. *[See Chart Below]*

U.S. Consumer Financial Obligations Total
% Disposable Personal Income | 2010:3Q 16.8%



Source: ISI Group

Holiday retailers benefitted from improving consumer balance sheets. US retail sales for the S&P jumped 5.5% in the holiday season which is the best in five years vs. 4.1% in 2009.

The political environment has provided some comfort to investors as well. The President signed the extension of the Bush tax cuts for two years and as an added stimulus lowered the payroll tax for employees by 2% for 2011. The Republican House of Representatives is seated in early in January with the intention of being more fiscally responsible.

Finally, the research firm Ned Davis reports that $2.8 trillion is invested in money markets. The Fed has signaled the desire to keep Fed Funds rates low at least through 2011 keeping the money market yield at virtually zero and there continues to be pressure to find higher yielding assets. As investors continue to grow more comfortable with the stock market some of the money market assets should find their way into stocks.

A problem ignored is not a problem solved

It is always amazing to watch the stock market shrug off bad news as confidence improves. Most of the issues that affected the stock market and the economy in the first half of the year have not subsided. Europe is still in a bad way with almost no economic growth, spiraling debt and rising bond yields as the debt of several countries faces a downgrade. The steps necessary to get back to fiscal health have not gone down well for the citizens in any of the countries facing a debt crisis. The healthier European countries (namely Germany) through words and actions have staunchly defended the European Union and the debt of the ailing countries, which has helped postpone the crisis but there will be further pain.

China has long been an engine of worldwide economic growth. The Chinese central bank has tightened twice now in an attempt to slow down growth and keep inflation under control. The Chinese stock market responded by declining more than 14% in 2010 which made it the worst performer among the world's major stock markets. China is very important to the world's economic health and slower growth in China will affect the rest of the world.

Unemployment continues to be a large concern domestically not having moved down at all. Hiring in the private sector should improve as the economy improves if businesses gain confidence there will be no surprises in the tax or regulatory environment. However, the hiring in the private sector may be offset by the downsizing of many state and local governments as municipalities deal with the continuing crisis of less tax revenue and deficit budget spending.

These continuing concerns along with the constant threat of an unforeseeable international crisis give us confidence that those clients who own bonds as part of a balanced portfolio will be happy they do during 2011. Real rates of return are currently high for bonds given that the yield on the 10-year Treasury is up nearly a full 1% without core inflation doing much of anything. As David Rosenberg of Gluskin Sheff states: "*Everyone seems to detest the Treasury market even though there is not a shred of evidence the Fed is going to tighten policy this year and the Core PCE inflation rate on a three-month basis is a mere 30 basis points above the zero line.*"

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Conclusion

We are optimistic for the stock market entering 2011 and do not believe the pundits who are forecasting a bond market disaster in 2011. The current environment of steadily improving economic growth should bode well for stocks although we still have miles to go before the unemployment rate is back down to acceptable levels and the housing market begins to improve. We believe it still makes sense to have balance in your portfolio and there will be a time in 2011 where you will be glad you do—either through a balanced portfolio or an all-fixed income portfolio.

We look forward to a successful 2011 and wish you the best in the year ahead.

Bond Market Overview *continued from page 1*

There could be many reasons for the sharp increase in interest rates, but primarily it is that economic expectations for growth have improved, regardless of whether these expectations are long lasting or justified. Improving economic expectations go "hand in hand" with higher interest rates and higher expectations for possible inflation. What expectations have changed recently?

Extension of the Bush administration tax cuts

The November mid-term elections gave impetus to the re-evaluation of future Federal tax policy. With the Republican Party gaining a majority in the House of Representatives, and narrowing the "gap" in the Senate, expectations for marginal tax rates reverting back to the higher rates in existence prior to the Bush administration, were now less certain. The push by the leadership of the newly elected majority party, along with some of the more moderate Democratic representatives in the House and Senate, to address the "sun setting" of the current tax law became a major negotiating issue between both Parties and President Obama. The end result of these negotiations is now certain. The current marginal tax rates will be extended for two more years for everyone. The extension of current tax policy improves expectations that individuals and small businesses will have more disposable income than they would have had to invest and consume. However, much of this was already expected by the market, at least for those income producers earning less than $200,000 to $250,000. What was not expected, which creates more fiscal stimulus, is the 2% payroll tax "holiday." As part of the negotiations the Congressional leadership and President Obama agreed to provide working taxpayers with a more immediate tax break by reducing the Social Security withholding tax for all of 2011.

It can be argued that maintaining current tax rates for those earning above the threshold income levels mentioned is less stimulative. Nonetheless, it is still keeping money in the hands of private sector consumers and investors versus the public sector. Since one of the important goals for our economy is to increase private sector jobs and ultimate demand, then extending the tax rates to everyone is still a marginally stimulative fiscal policy. It remains to be seen whether the temporary reduction of payroll taxes will give the economy a lasting boost.

Consumers typically alter their behavior based on permanent changes to their job situation, income, and wealth. However, we do believe that the additional withholding tax stimulus provides one more reason why a double dip recession is not very likely.

Friendlier Business Climate

There is an expectation that the November mid-term election results will lead to a politically "warmer" and more receptive environment for business. There seems to be a growing consensus that the President will most likely have to alter the liberal agenda and work with the new Congress in paring back spending in areas not directly associated with business development and new job creation.

Additionally, businesses have the added support of the Federal Reserve Bank in keeping short-term rates low and providing ample liquidity for business to access working capital. If these expectations materialize, then there is a greater probability that business confidence will improve as will their willingness to expand and create more jobs. Improvement in employment means growth. So, here too we have expectations for growth that, while good for the economy, are not so good for bond prices as longer-term interest rates rise. A friendlier business climate may affect investment behavior marginally, but ultimately businesses will make capital investments when demand for their products and services returns.

Improving Equity Market

The improving equity markets have also contributed to improved expectations for growth. The Dow Jones Industrial Average returned approximately 8% in the 4th quarter. Other major U.S. equity indices also showed impressive returns; the S&P 500 gained 10.75%, while the NASDAQ Composite Index gained approximately 12% for the same period. So, for much of the year the major U.S. equity indices showed little proof that expectations for economic growth were bound to improve except for the last 3 months. The equity market may also be feeling more confident after Federal Reserve Chairman Bernanke's Opinion article appeared in the Washington Post on November 4th. The opinion article was the Chairman's attempt to be more transparent (maybe defensive) about monetary policy and Quantitative Easing. Among other things, it was evident that Mr. Bernanke subscribes to the "wealth effect" as a way to get consumers to spend more. "…and higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."[1] Is this sustainable or merely a short-term reaction to economic conditions not getting worse? Only time will be able to determine that.

Commodity Prices & Inflation Expectations

Commodity prices also reacted very significantly to growth expectations in the 4th quarter. The broad basket of commodities represented by the S&P GSCI (Goldman Sachs Composite Index) returned almost 13.5%.

Some of the individual commodity sectors such as Energy, Industrial Metals, Precious Metals, and Agriculture also showed double-digit returns. The price of spot Gold alone has increased approximately 8.5% while Crude Oil Futures have increased more than 10.5%. Are these prices moving higher as a result of final demand for commodities or are prices increasing in anticipation of inflation, which has yet to materialize?

Needless to say, the U.S. is not the only consumer of commodities in the world. The demand from other economies is indeed having an effect on these prices. However, that's not to say that those investors and speculators that are investing in commodities Futures and Options may not also be having an impact on prices of the underlying commodities themselves. The volume of activity in the Commodities markets has also been affected by the increased accessibility of these hedging instruments through the increasing popularity of Exchange Traded Funds and Exchange Traded Notes. The hyper-inflation fear could be at the center of this speculation. However, we're not sure which is the "chicken" and which the "egg." Are commodity prices increasing because of inflation or is inflation increasing because of commodity prices? We don't know? We do know that this fear is not supported by the recent data, nor is it supported by the Federal Reserve Bank's monetary policy. The Consumer Price Index is increasing at a 1.6% annualized rate over the last three months, while the Core CPI (without Food & Energy) is growing at a 0.4% annualized rate. Neither of these indices is showing signs of "runaway" inflation.

Changing Expectations – Are they well founded?

We've only listed some of the more plausible reasons for the 4th quarter rise in interest rates and the poor performance of bonds. We should also mention that the month of December has traditionally been a very bad time of year for market liquidity. Most bond trading desks don't typically buy securities that they cannot immediately sell. No trader wants to end the year with excess inventory of bonds on his/her books. So, there is also some seasonality that affects the bond market in the last month of every year.

While the prospects for short-term growth have improved, we don't believe that many of the reasons mentioned above should give us (nor you) reason to worry about the biggest concern for the bond market – inflation. The extension of the tax rates and the new payroll tax stimulus alone, are not inflationary. The notion that government spending is inflationary is not supported by any study that I have ever read. The fear with government spending is deficit spending, which increases debt and the amount of tax revenues that goes toward servicing the debt. During periods of economic growth, the overall government debt is rarely a concern. However, in times when growth rates are negative (recessions) or very low, as they are now, the debt burden becomes a much more sensitive issue. It is a sensitive issue because (without sustained economic growth) debt reduction can only be achieved through increasing taxes or reducing spending.

Neither, increasing taxes nor spending cuts are economically stimulative policies. Since we now know that Federal tax rates will not be increasing, we will have to see how the market reacts to the expected cuts in spending.

Our economy still has to deal with other significant questions regarding employment. Where will the new jobs be created? What kind of jobs will be created? Do the currently unemployed have the skill sets to meet these job requirements? In our opinion there are no short-term solutions that can help to answer these questions. The temporary tax incentives and easy monetary policy of the Federal Reserve will not provide permanent or long lasting solutions to our country's employment needs. Furthermore, we believe that the current financial heath of state and local governments will result in more cuts in services, more layoffs, and perhaps higher taxes. So, "what the Federal Government giveth, the State and Local Governments may taketh away." Therefore, I am not as sanguine as others may be about the longer term prospects for growth and possible inflation.

I would caution all of our readers about not getting too excited about the recent rise in interest rates. The following is what I consider "key" from a recent e-mail to our clients:

It is very important to remember that, even in periods of rising interest rates and falling bond prices, the face value of the bond will be returned to you when your bonds mature. Plus, you receive your interest payments for the life of the bond. At Howe & Rusling, we are acutely aware of the cyclical phenomenon of interest rate changes and we invest accordingly. Where appropriate, we have moved to shorten the average maturity of our clients' bond holdings because shorter term bonds have less price sensitivity to changing interest rate levels. Another important consideration in our bond investing is that we do not buy very long-term bonds, in the 20 year + range. The prices of these bonds are much more sensitive to market changes.

[1] Washington Post, November 4, 2010 - *What the Fed did and why: supporting the recovery and sustaining price stability*, by Ben S. Bernanke

John M. Plunkett
Senior Business Development Manager

Howe & Rusling is pleased to announce the hiring of Senior Business Development Manager John M. Plunkett. In his role, Mr. Plunkett will be focused on cultivating new relationships, with the goal of contributing to the growth of Howe and Rusling. Mr. Plunkett brings over 20 years of Financial Services business experience and will be working in the New York, New Jersey, Connecticut region. This addition to staff is further testament of our pledge and commitment to serve the Institutional and High Net Worth marketplace.