Fourth Quarter, 2010

Summary
U.S. economic growth has turned positive, but it remains below trend and reflects high unemployment, portending low interest rates for an extended period. Taking from its playbook for 1958, the last time the U.S. faced serious deflationary pressures, the Federal Reserve has instituted aggressive policies that target economic stimulus and a core inflation rate of 1.5%-2.0%.

The initial stages of the recovery were largely attributable to an inventory rebuilding cycle, uncharacteristically driven by manufacturing and export orders. More recently, domestic economic growth has accelerated, perhaps moving from recovery into modest expansion.

Financial lending conditions remain accommodative for corporations. Even with a sudden upward shift in the yield curve, rates remain below the highs of early 2010. More significantly, as Treasury rates increased, trading among lower quality corporate bonds improved, and spreads versus Treasuries declined, all indicating that an appetite for risk had returned. The combination of a steepening yield curve, declining Treasury spreads, and an increased risk appetite, serve to suggest that Fed policy is working.

Current prices for the various S&P indices appear fairly valued. The price-to-earnings multiple for the S&P 500 Index is near its long-term average. Earnings have advanced nicely from the low of 2009, and the S&P 500 Index earnings estimates are expected to rise 14% in 2011. Continued strength in earnings should provide the markets with longer-term strength and support. Moreover, equities appear attractive versus other asset classes, e.g., fixed income.

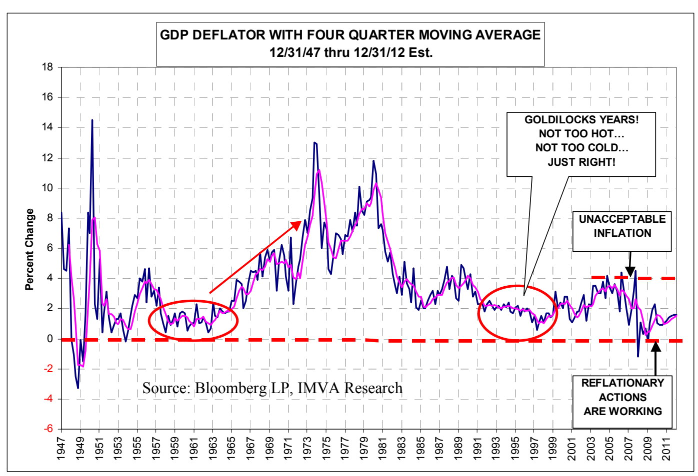
In Search of Goldilocks
Enacted in 1978, the Full Employment and Balanced Growth Act (Humphrey-Hawkins Act) sought to curtail the stagflation, meaning low growth coupled with high inflation, that marked most of the 1970s. This legislation explicitly instructed the Federal Reserve to implement policy that would promote the dual mandates of full employment and price stability. Although that legislation has since expired, these dual mandates continue to guide Fed policy in combating the significantly different challenges of today, slow growth and deflation.

> *"The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."*[1]

Beginning with the fall of the Berlin Wall, in 1989, globalization and democratization became the driving themes behind global growth. Cheap labor in emerging countries generally produced excess capacity and lower prices, and developed country consumers reaped the benefits. For a period during the 1990s, the economy was referred to as the "Goldilocks Economy" – not too hot, and not too cold. The U.S. consumer became the buyer to the world. Personal and government indebtedness increased as interest rates declined, and global trade deficits grew. By definition, as imports increase and deficits worsen, imbalances appear that promote deflation. When the recession hit, U.S. consumers found it necessary to curtail spending and deleverage abruptly. Similarly, U.S. corporations cut spending and fired workers, all of which created more downward pressure on pricing. A global economic rebalancing was in the making.

In the past ten years, China has produced almost as much world GDP growth as the U.S., even though the U.S. economy started the year 2000 at nearly eight times the size of China's. Since 2000, the BRICs (Brazil, Russia, India, and China) have grown their percentage of world GDP from 8% to 17%, while the U.S.'s percentage has declined from 31% to 24%. Assuming IMF (International Monetary Fund) world growth projections, by 2015 U.S. GDP will drop to ~22% of world GDP, and the BRIC percentage of world GDP will climb to ~22%. According to Goldman Sachs, consumer spending in Brazil, Russia, India, and China may surpass U.S. purchases in the next 15 years.

Going forward, global rebalancing has the potential to impair significantly U.S. long-term economic growth, especially given U.S. debt burdens and trade imbalances. While U.S. economic growth has turned positive, most projections continue to point toward below average growth, high unemployment, and low interest rates for an extended period. Taking from its playbook for 1958, the last time the U.S. faced serious deflationary pressures, the Fed has instituted policies directed toward aggressively providing economic stimulus while targeting a core inflation rate of 1.5%-2.0%. In sum, the Fed seeks a Goldilocks outcome, an economy that is neither too hot nor too cold.

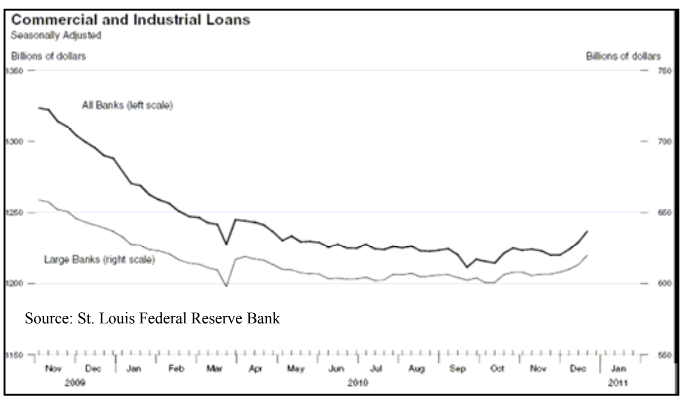


Economic Trends

The U.S. economy has been in recovery for six quarters, albeit with below average growth and dismal employment statistics. The initial stages of the recovery were largely attributable to an inventory rebuilding cycle, uncharacteristically driven by manufacturing and export orders. Recovery growth decelerated in mid-2010, as inventory replacement waned, and sovereign debt problems in Europe heightened volatility among financial markets, raising fears of a double-dip recession.

More recently, domestic economic growth has accelerated, perhaps moving from recovery into expansion. ISM manufacturing re-accelerated, expanding for its 17th consecutive month on strong new orders, increased production, and employment growth. ISM non-manufacturing increased for its 12th consecutive month, reaching the highest level in four years on strong business activity, rising orders, and to a lesser extent, growing employment. Both ISM measures indicated rising input prices. With increased capital spending driving capital goods orders higher, factory orders have been encouraging.

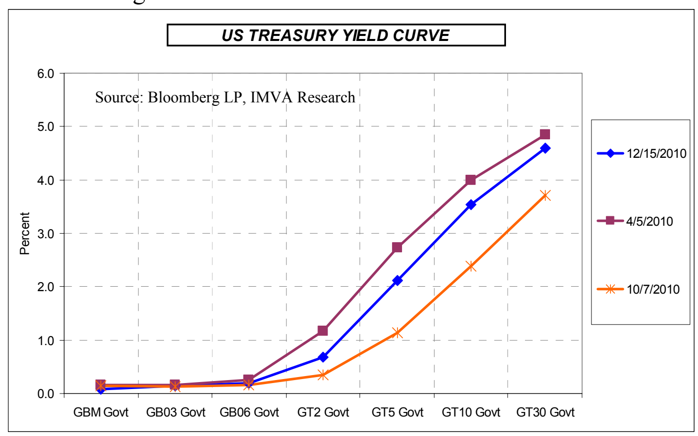
Jobless claims have declined, grudgingly, with the reported unemployment rate recently dropping to 9.4%, an admittedly high reading versus most data since the Great Depression. Hours worked also increased, and non-farm productivity grew 1.9% during the third quarter. Most surprising, perhaps, was an increase in residential construction spending. Nonresidential construction held up better than expected as well. As seen in the St. Louis Federal Reserve chart, commercial and industrial loan activity has turned up following a very long drought in demand.



Given these improvements, and with inflation expectations beginning to stabilize, it appears that the Fed's policy may be working toward moving the economy toward private capital formation and self-sustaining growth. Still, expectations for below-trend growth remain. Federal Reserve Chairman Ben Bernanke's most recent comments caution that, "It could take four or five more years for the job market to normalize fully."

Financial Conditions

Financial lending conditions remain uncommonly attractive and accommodative for corporations, regardless of the recent backup in interest rates. Mid-2010's financial uncertainty and market volatility served as the catalysts that drove investors toward the security of fixed income and pushed interest rates to low levels not seen in more than fifty years. Numerous corporations took advantage of generational low rates, borrowing billions, and in many cases, replacing previously issued debt with higher debt obligations. Interest rates on longer dated U.S. Treasury obligations bottomed in early-to-mid October. Thereafter, evidence of improving economic data began to emerge; fear subsided markedly; interest rates edged higher; and, by mid-December, most talk of a double-dip recession had ceased. Currently, even with the sudden upward shifts in the yield curve, short-term rates remain low, and U.S. Treasury Note and Bond rates remain below the highs of early 2010. More significantly, as Treasury rates increased, lower quality corporate bond trading improved, rates only marginally increased, and Treasury spreads declined, all indicating that the flight-to-quality was over and an appetite for risk had returned. The combination of these conditions, namely, a steepening yield curve, declining Treasury spreads, and an increased risk appetite, serve to suggest that Fed policy is working. Expectations for forward growth are improving, and low interest rates and somewhat relaxed lending standards remain accommodative and stimulative toward economic growth.



Monetary Trends

In his most recent appearance before the Senate Budget Committee, Federal Reserve Chairman Bernanke addressed monetary policy with the following comment:

> *"Although it is likely that economic growth will pick up this year and that the unemployment rate will decline somewhat, progress toward the Federal Reserve's statutory objectives of maximum employment and stable prices is expected to remain slow. The projections submitted by Federal Open Market Committee (FOMC) participants in November showed that, notwithstanding forecasts of increased growth in 2011 and 2012, most participants expected the unemployment rate to be close to 8 percent two years from now."*

In light of his comments, and his later description of the economic outlook as "still unsatisfactory," it is likely that monetary policy will continue to tilt toward providing stimulus and fostering economic expansion. In late summer, the Federal Open Market Committee (FOMC) began signaling that it was considering additional monetary policy accommodation with further asset purchases. In November, the FOMC formally announced its intent to purchase an additional $600 billion in Treasury securities. This program will terminate by the end of June 2011. Given the Fed's comments about high unemployment and its expectations for slow employment growth for years, low short-term interest rate policy would be expected to remain in place.

Technical Market Trends

As has been the case for an extended period, many of our short-term market measures are signaling over-bought conditions. In isolation, these measures are not perfect timing tools. However, in conjunction with other components of our economic and market analysis, over-bought readings do signal caution. From the July 2nd, 2010 correction bottom in the S&P 500 Index, the market has advanced a healthy 24%. Given such an advance over a six-month period, one might expect a pause or perhaps a rotation in market leadership, with rising volatility and interest shifting to stocks that have lagged.

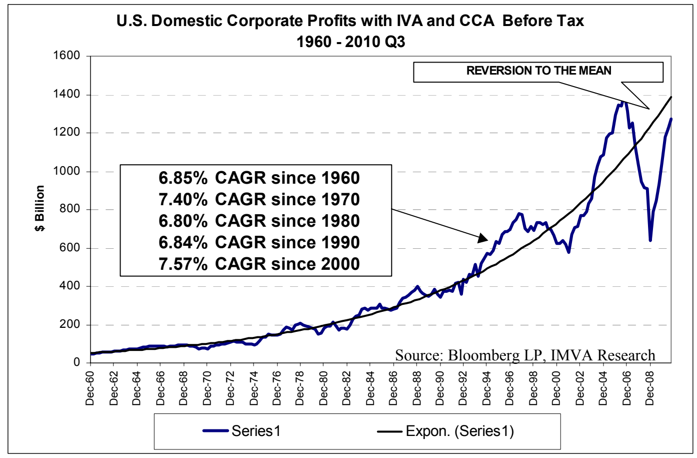
Sentiment Indicators (Contrary Indicators)

IMVA's sentiment indicators reflect short-term, over-bought conditions as well, representing a marked change from those seen in July. As indicated in the 3rd quarter commentary, during the July market trough, the American Association of Individual Investors (AAII) "Bullish" indicator registered its lowest reading since the market cycle low of early March 2009, the market bottom. Recently, Bullishness has been the highest since January 2007, and Bearishness measures have retraced to levels not seen since early 2006. The Total Put-to-Call ratio and market volatility indexes provide similar implications. For the most part, risk aversion in the financial markets has eased, perhaps indicating that heightened volatility looms on the horizon.

Equity Market Earnings & Valuation

Generally, current prices for the various S&P indices appear fairly valued. For example, at 15x trailing earnings, the S&P 500 Index is near its long-term average. Valuation aside, earnings have advanced nicely from the $65.27 low of 2009. Presently, the S&P 500 Index earnings estimates stand at $95.16 for 2011, up 14% versus an expected $83.71 in 2010. Despite recent strength in equities, they appear attractive versus other asset classes, e.g., fixed income. At this stage in the cycle, future success in equities likely depends on the magnitude of further earnings improvement.

As seen in the embedded chart, domestic corporate profits also have recovered nicely. This measure is a comprehensive view of profits from all U.S. corporations, reported by the Bureau of Economic Analysis. Additionally, U.S. corporate net cash flow has grown to new high levels, and corporate profit margins remain healthy. If both trends suggest the potential for a continuation in healthy profits, absolute valuation levels may,



nonetheless, portend a short-term pause or rotation in the markets. Longer-term, continued strength in earnings should provide the markets with longer-term strength and support.

Conclusion

Economic growth has reaccelerated from the mid-year lull of 2010. The preponderance of recent evidence supports upward revisions in economic growth and the likelihood of the U.S. economy's transitioning from a recovery phase into economic expansion. Regardless, economic growth remains fragile and in a below trend trajectory. Federal Reserve policy appears to be stimulating growth. Greater levels of growth and stability will need to emerge before the Fed withdraws its accommodative stance and raises interest rates. Short-term technical and sentiment indicators appear over-bought, and market valuations appear fair. These conditions imply the probability of a pause in the market advance; however, evidence of improving earnings and earnings estimates appear supportive over the longer-term, barring unexpected or exogenous sudden shocks.

For an in depth review of our Market Pillars and Charts, go to: http://www.imva.net/market-pillars/.

[1] http://www.federalreserve.gov/aboutthefed/section2a.htm.

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