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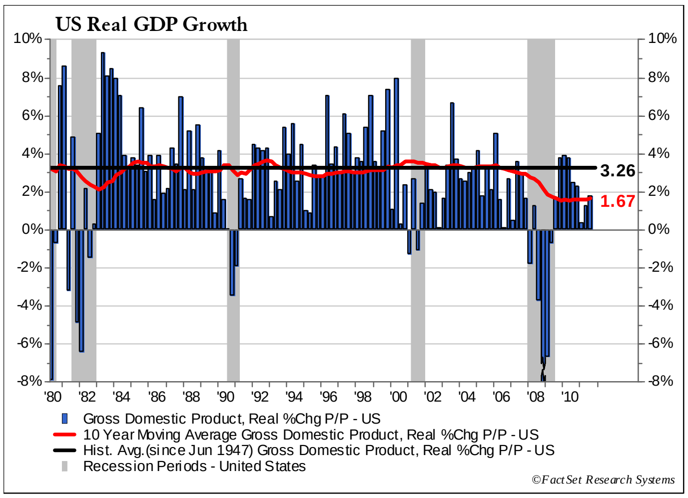
Market Review

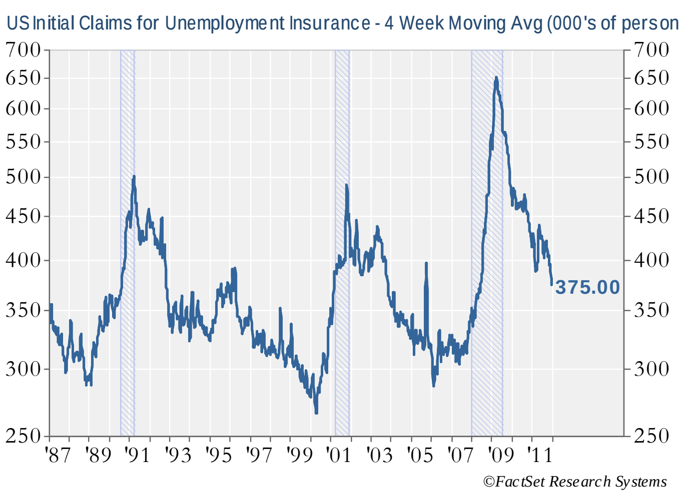
December 2011

Economic Review

Third quarter real Gross Domestic Product was revised downward again. According to the third estimate released by the Bureau of Economic Analysis, third quarter GDP is reported to have increased 1.8% annualized, less than the 2.0% second estimate released in November and the 2.5% preliminary estimate reported in October. The chart below shows the quarterly real GDP growth during the past thirty years along with a historical average since 1947 and a 10 year moving average. The third quarter estimate of 1.8% is nearly half of the historical average of 3.26% and barely above the 10 year moving average.

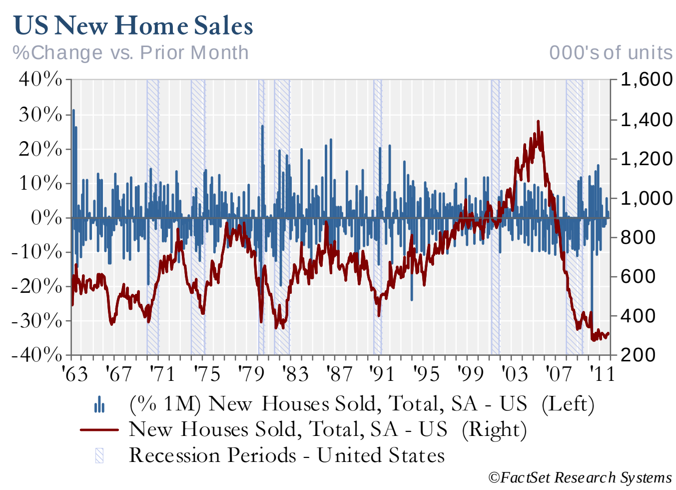


The U.S. initial claims for unemployment insurance - four week moving average trended down during December and stood at 375,000. The weekly claims were below 400,000 during each of the four weeks in December, dipping to 366,000 on December 16th, the lowest level since May 2008. The unemployment rate dropped to 8.5% in December from a revised 8.7% in November.



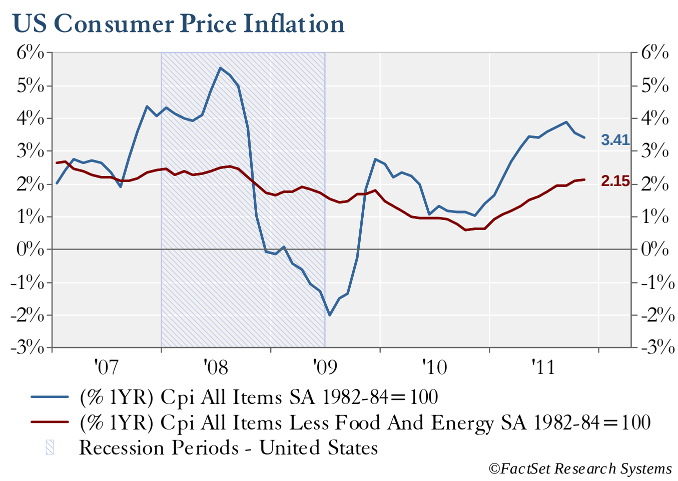
The improving job outlook helped the Conference Board Consumer Confidence Index increase for the second straight month to reach an eight month high of 64.5 in December (1985=100) and significantly higher than October's post-recession lows of 40.9. The index of U.S. leading economic indicators, which has risen for six consecutive months, increased 0.5% in November led by an increase in building permits and the spread between short term and long term interest rates. The reliability of the spread term in a zero interest rate environment has been called into question by many economists including the San Francisco Fed. The index of coincident indicators, a gauge of current economic activity, climbed 0.1%. The index of lagging indicators also increased 0.1%.

The housing market recovery continues to remain sluggish. According to the Case-Shiller 20 city Index, U.S. home prices declined 1.2% in October from a month earlier and fell 3.4% versus a year ago. November existing home sales rose 4% to a seasonally adjusted annual rate of 4.42 million units versus a consensus estimate of 5 million units. October existing home sales were revised downwards from 4.97 million units to 4.25 million units. November new home sales increased 1.6% to a seasonally adjusted 315,000. The year to date data for new home sales indicates that 2011 could be the worst year for new home sales since 1963. Housing starts increased 9.3%, while building permits increased 5.7% in November.



The December Institute of Supply Management (ISM) Manufacturing Index climbed to a six month high of 53.9%, up from 52.7% in November indicating an expansion for 29 straight months. The ISM Non-Manufacturing Index also expanded for the 25th consecutive month coming in at 52.6, up from 52 in November. A value above 50 indicates an expansion. In contrast to the ISM surveys, November industrial production dropped 0.2%.

Retail sales increased just 0.2% versus the consensus of 0.6% in November, but were still up 6.8% versus a year ago. Capacity utilization dropped to 77.8% and is nearly 3% below the average since 1967. Personal Consumption and Personal Spending increased 0.1% each during November. The November headline CPI remained unchanged while the core CPI rose 0.2% month over month. The headline CPI is up 3.4% year over year while the core CPI is up 2.2%.



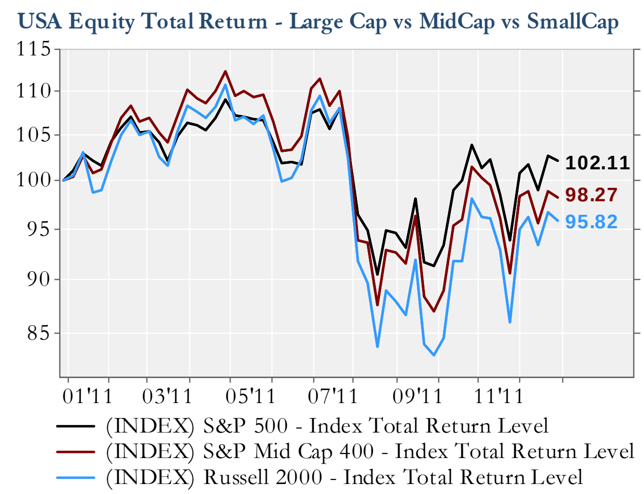
The Federal Reserve left interest rates unchanged and sounded slightly more upbeat about the U.S. economy. Congress extended the payroll tax cut plan for two months after a contentious debate and also agreed to negotiate a longer-term extension.

In Europe, all European Union nations except the UK agreed to draft a new treaty for deeper economic integration. S&P put 15 of 17 Eurozone countries, including France and Germany, on alert for downgrade on concerns over deepening debt crisis. The European Central Bank (ECB) cut rates by 25 bps early in the month and followed up by offering unlimited three year funding (Long Term Refinancing Operation – LTRO) to banks at 1%. A total of 523 banks grabbed close to half a trillion Euros. Within a week, the cash held with ECB surged dramatically indicating that the banks are hoarding, rather than lending or circulating, the money.

Equity Markets

The equity markets were relatively quiet in December as the VIX Index dropped to its lowest level since July. Though the year was characterized by a sovereign debt crisis in Europe, political gridlock in the U.S. over the deficit, natural disaster in Japan and civil unrest in the Middle-East, the U.S. stock market ended close to where it began the year. The S&P 500 Index gained 1.02% in December to wrap the year with 2.11% gains.

Size mattered in 2011 as U.S. large cap outperformed mid cap, which in turn outperformed small cap. S&P midcap and Russell 2000 returned -1.73% and -4.18% respectively during 2011. Growth stocks generally trumped value stocks across all cap sizes.



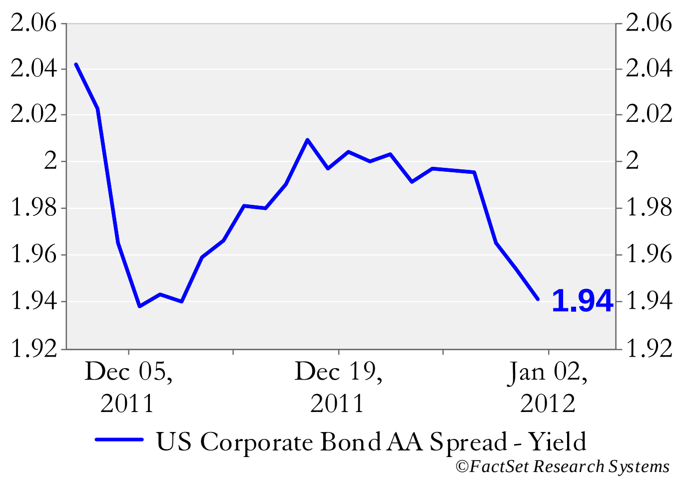
International stocks did not fare as well as U.S. stocks in 2011 with emerging markets declining significantly. Measured in US Dollars, the MSCI World Index was flat in December and is down 5.02% for the year. The MSCI EAFE Index declined 0.94%, bringing the year's loss to 11.73%. The MSCI Emerging Markets declined 1.2% and is down 18.17% for the year. Measured in their local currencies, the FTSE 100 and STOXX 600 indices gained 1.25% and 1.92% respectively in December and declined 2.18% and 8.61% for 2011.

Bond Markets

Fixed Income continued to be a bright spot in December as the Eurozone crisis spurred a broad flight to safety. The Barclays Capital U.S. Aggregate Government Treasury Index gained 0.97% in December and is up 9.81% for the year, the best yearly returns since 2008. The U.S. bond market, as measured by the Barclays Capital U.S. Aggregate Index, added 1.1% in December to close the year up 7.84%. Barclays Capital U.S. Aggregate Government Treasury Long Index returned an astonishing 29.9% during 2011.

Treasury yields edged up during the early days of December on better than economic data and news that an agreement was reached at the European summit to help resolve the sovereign debt crisis. However the investor optimism quickly faded as credit rating agencies put several Eurozone countries on potential down grade list. The 10-year Treasury yields decreased 26 basis points by December 19th to close at 1.81% amid concerns European officials were making little progress. Treasury yields climbed again the following week after a lackluster 7-year note Treasury auction, an unexpected increase in German business confidence and on hopes the ECB's LTRO would ease the funding crisis for European banks. The 10 year Treasury yield climbed above the 2% mark to reach 2.03% by December 23rd. However, renewed concerns regarding Euro zone sovereign debt crisis spurred demand for U.S. Treasuries towards the end of the month causing 10-year Treasury yield to fall each day of the holiday shortened week. The 10-year Treasury yield dropped 20 basis points in December to close the year at 1.88%. The 30-year Treasury yield drifted lower by 16 basis points to finish at 2.90%.

Corporate debt spreads were range bound during December as can be seen in the chart below. U.S. corporate bond AA spreads narrowed by 10 bps to close at 1.94. Barclays Capital U.S. Corporate Credit and U.S. High-Yield Index increased 2.14% and 2.66% respectively.



The UK 10 Year GILT yield declined 17 basis points to close at 1.97% in December. The German 10 Year Bunds decreased 43 bps to close at 1.84%. The UK Gilt market was the top performing government bond market returning 17% in 2011 and outperforming German bunds and U.S. Treasuries.

Currency

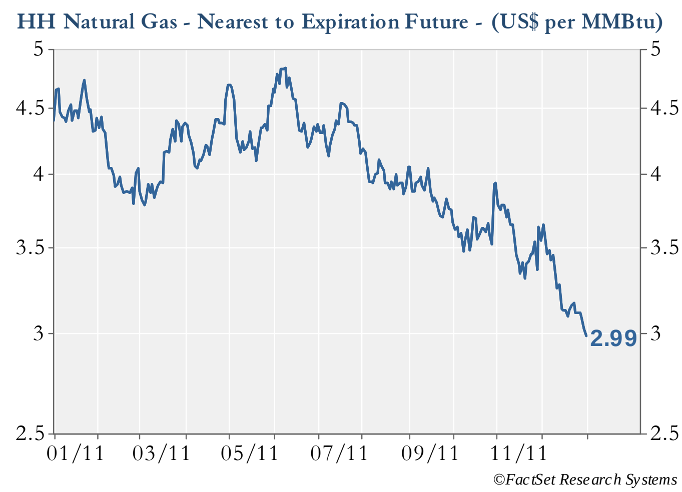
The US Dollar Index, which tracks the US Dollar against a basket of six currencies, increased 2.29% last month and closed the year up 1.46%. The Euro hit an eleven month low against the US Dollar and 10 *year* low against the Japanese Yen. The Euro depreciated 3.6% against the US Dollar and closed the year at 1.298 USD/EUR. The British Pound depreciated 1.2% to close at 1.5541 USD/GBP in December.

Commodity Markets

Commodity prices came under pressure during December on signs of a slowing Chinese economy and Euro sovereign debt concerns. The Dow Jones UBS Commodity Index declined 3.75% last month and ended 2011 down 13.3%. The energy heavy S&P GSCI Commodity Index declined 2.11% in December and finished the year down 1.2%.

Precious metals and industrial metals lost 11.1% and 4% respectively while agricultural commodities gained 3.9% in December. Gold declined 10.5%, to close at $1566.8/oz. The precious metal was up 10.2% for 2011, despite the recent decline.

Natural Gas, Silver and Zinc were the bottom three single commodity indices declining 16.7%, 14.9% and 11.4% in December. Natural Gas prices were pushed lower on increasing supply and mild weather while Silver and Zinc prices fell as economic indicators from China suggested a slowdown of its economy. Wheat, Nickel and Corn were among the best performing commodities with returns of 8.5%, 6.9% and 6.3% respectively last month. Prices of grains surged primarily due to adverse weather conditions, while Nickel saw an increased demand, especially from emerging economies.



During 2011 Gas Oil, Unleaded Gasoline, Orange Juice and Brent Crude enjoyed the strongest gains with year-end returns of 20.2%, 19%, 18.9% and 17.5% respectively. On the other end, Natural Gas, Wheat and Cocoa were the bottom of the pack declining 44.5%, 34% and 32.4%.