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QUARTERLY ECONOMIC UPDATE

A review of 4Q 2010

QUOTE OF THE QUARTER
"Always be a first-rate version of yourself, instead of a second-rate version of somebody else."
– *Judy Garland*

QUARTERLY TIP
Take a look at what is on your credit report. You are entitled to one free copy from each credit bureau annually. Why not have a look?

THE QUARTER IN BRIEF

The consumer was the hero of the fourth quarter. In the last three months (and especially in the last six weeks), consumers opened their wallets and pocketbooks and grew more confident about the state of the economy. In Washington, the President and Congress collaborated to devise short-term fixes for America's major tax issues. The Federal Reserve announced plans for another round of monetary easing. There were signs of hope for the housing market, but also signals that home prices had yet to bottom out. We didn't see a reduction in unemployment. Yet when all was said and done, the S&P 500 had gained 10.20% for the quarter.[1]

DOMESTIC ECONOMIC HEALTH

In December, the Commerce Department told us that consumer spending accelerated to an annualized pace of 2.4% during the third quarter. It improved by 0.7% in October and 0.4% in November – meaning five straight months of increases. By the end of December, the Reuters/University of Michigan consumer sentiment index indicated a peak of confidence among consumers unseen since June.[2,3,4]

Retail sales increased by 1.7% in October and 0.8% in November, Commerce Department figures indicated. MasterCard's SpendingPulse eCommerce Index measured a 15.4% increase in year-over-year online sales between October 30 and December 23. By December, chief economists at Wall Street firms had revised their estimates of 4Q 2010 consumer spending upward – Morgan Stanley forecast +4.4%, JPMorgan Chase +4.0% and IHS Global Insight +4.2%.[4,5,6]

All consumers could rejoice about the tax accord struck in the nation's capital in December. The fight over extending the Bush-era tax cuts to the wealthiest Americans turned out to be little more than a skirmish. Following a compromise between President Obama and Congressional Republicans, the 2010 Tax Relief Act became law on December 17. It extended the Bush-era tax cuts for all Americans through 2012, cut (employee) payroll taxes by 2.0% for 2011, and extended federal unemployment benefits for another 13 months. It also brought back the estate tax at 35% with a $5 million individual exemption.[7,8]

The Federal Reserve decided to use one of the few options it had left to try and stimulate inflation and the broad economy. In early November, it said it would buy $600 billion worth of Treasury bonds by mid-2011, and it stated plans to purchase up to $900 billion in debt by the end of 3Q 2011. The possible effects: lower long-term interest rates, lower bond yields and a weaker dollar, all factors which could make equities and real estate more attractive investments. Detractors saw the potential for stock and commodities bubbles - and a trade war, as U.S. exports could become cheaper as a consequence.[9]

The jobless rate was 9.6% in October and 9.8% in November. Yet by Christmas, initial claims had fallen to a seasonally adjusted 388,000, 40.4% below the recessionary peak of 651,000 reported by the Labor Department in March 2009.[10,11]

America's manufacturing and service sectors appeared healthy, at least by the twin surveys at the Institute for Supply Management. Its December reports found the service sector rate of expansion improving 2.1% in December to 57.1% and the manufacturing sector rate of expansion improving 0.4% to 57.0 for December. The service sector had been expanding for the past 12 months.[12]

GLOBAL ECONOMIC HEALTH

In Europe, the big news of the quarter concerned debt ratings. Moody's Investors Service slashed Ireland's credit rating by five levels in mid-December, and both Moody's and Standard & Poor's indicated that Portugal could be in line for a downgrade. Spain's credit rating and Greece's bond rating were also put up for review by Moody's. S&P lowered its debt rating of Belgium late last month, while Fitch downgraded the credit rating of Hungary (not an EU member) to just above junk status.[13,14]

In the Asia Pacific region, all eyes were on a) China's central bank and b) the continuing tension between North Korea and South Korea. In October, China reported its annualized growth slowing to 9.6% in the 3Q with inflation hitting its highest level in two years in September (3.6%). China's central bank raised its benchmark interest rate twice in the quarter; at this writing, it is 5.81%. We learned third-quarter growth had been very strong in India (8.9%) and yes, even in Japan (4.5%). Economies across the region grew worried about the Fed's bond-buying initiative, with its potential to boost the risk of asset bubbles and inflation.[15,16]

WORLD MARKETS

The 4Q saw most of the world's benchmarks adding to YTD gains. England's FTSE 100 rose 6.3% in the quarter and the broader Dow Jones Stoxx Europe 600 advanced 6.2%. The Nikkei 225 was up 9.2% for the quarter, and Taiwan's TAIEX rose 8.9%. Gains like these resulted in some very pleasant year-end numbers for some notable indices: South Korea's KOSPI, +21.9%; Mexico's IPC All-Share, +20.0%; India's Sensex, +17.4%; Germany's DAX, +16.1%; Canada's TSX Composite, +14.4%. Other indices racked up lesser annual gains (FTSE 100, +9.0%; Hang Seng, +5.3%; Bovespa, +1.0%). Some indices slipped for 2010, even after a good 4Q: the Australia All Ordinaries index (-2.6%), the Nikkei 225 (-3.0%), the CAC-40 (-3.3%) and especially the Shanghai Composite (-14.4%). The MSCI World Index had an +8.55% quarter en route to a +9.55% 2010 return, and the Emerging Markets Index posted a 4Q return of +7.05% to go +16.36% for the year.[17,18,19,20,21]

COMMODITIES MARKETS

Bulls ran rampant. Oil notched a 14.27% gain for the quarter on its way to a +15.15% year and a year-end price of $91.38 a barrel. Gold gained 8.66% in 4Q 2010 to settle at $1,421.10 per ounce on New Year's Eve. Copper gained 21.76% for the quarter. Across November and December alone, gold prices went up $100, silver prices rose 25%, copper prices climbed almost 20% and oil futures gained $12. Consequently, we saw some spectacular yearly gains for precious metals – 29.8% for gold, 83.7% for silver (not a misprint), 96.5% for palladium (not a misprint either), and 20.9% for platinum. In crops, sugar prices continued a climb of 93.5% from a June trough, concluding 2010 up 51.8%; coffee ended up 76.8% for 2010 while wheat rose 46.7% and soybeans gained 34.1%.[22,23,24,25]

REAL ESTATE

We know that existing home sales went north 5.6% in November after slipping 2.2% for October. We also know that the pace of new home sales improved by 5.5% for November after falling 10.1% in October (and rising 12.0% in September); new home prices were also up 8.0% for November. Is this anything like good news, or hope to build on? Maybe not. Unemployment, foreclosures, and several months of inventory overhang remained central dilemmas. Pending home sales, however, did rise for two straight months. They soared 10.0% (a record) in October and improved by another 3.5% in November.[26,27,28]

This was the quarter in which mortgage interest rates finally went up. In fact, they went up about half a point on fixed-rate loans. Freddie Mac noted the rise in average rates in its September 30 and December 30 Primary Mortgage Market Surveys: 30-year FRMs, 4.32% to 4.86%; 15-year FRMs, 3.75% to 4.20%; 5-year ARMs, 3.52% to 3.77%; 1-year ARMs, 3.48% to 3.26% (average rates actually declined).[29]

LOOKING BACK…LOOKING FORWARD

The Fed's bond-buying program (nicknamed QE2 by the media) and the mid-term elections (which gave Republicans control of the House of Representatives) helped to encourage stock market investors. Across 2009-2010, the S&P 500 gained 39.23%, the DJIA 31.92% and the NASDAQ a remarkable 68.22%.[1]

% CHANGE	2010	QTD CHG	1-YR CHG	10-YR AVG
DJIA	+11.02	+7.32	+11.02	+0.73
NASDAQ	+16.91	+12.00	+16.91	-0.74
S&P 500	+12.78	+10.20	+12.78	-0.47
REAL YIELD	12/31 RATE	1 YR AGO	5 YRS AGO	10 YRS AGO
10 YR TIPS	1.00%	1.48%	2.06%	4.03%

Source: online.wsj.com, bigcharts.com, ustreas.gov, bls.gov - 12/31/10[1,30,31,32]
Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.
These returns do not include dividends.

As the first quarter gets underway, there seems to be a renewed sense of optimism permeating the investor community and the media. The big red flags are mostly overseas – debt in Europe, the strong possibility of China's government putting some brakes on its growth. The recent spike in mortgage interest rates puts pressure on a housing recovery (perhaps rising rates will be subdued as a byproduct of QE2). At home, we seem to be witnessing renewed demand from the consumer, and we all know what the pleasant consequences of that might be – a boost in production, a related wave of hiring, and a perception of increasing prosperity and affluence that is good for both Main Street and Wall Street.

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