



## Is Stock Market Recovery Stage Over?

Stephen Rhea

Dear Clients & Friends:

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Alex Thompson

A strong 4<sup>th</sup> quarter rally propelled global stock markets to new two-year highs. U.S. mid- and small-cap equities were the big winners, as they turned in 2010 gains of 26%. Large U.S. stocks also performed well, with foreign equities close behind. Everything seemed to work, as bond markets also had an excellent year.

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John Laughlin

As of this writing, the S&P 500 stock index has now advanced over 90% since the market low in March 2009. It's also worth noting that the index's 15% advance in 2010 gave it its first consecutive double-digit gains since 1999. With the global bear market, financial crisis, and recession fading further into history, it is an appropriate time to take a look at where markets stand and at the possibilities that lie ahead. First, here is how the 4<sup>th</sup> quarter and 2010 ended:

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	<u>4Q</u>	<u>YTD</u>
Dow Jones Industrial Average	7.3%	11.0%
S&P 500 Index	11.7%	15.0%
MSCI EAFE Foreign Equity	6.6%	7.7%
MSCI World Index	8.7%	12.6%
Barclay's Aggregate Bond Index	-1.3%	6.5%

We believe the current phase of the surprisingly rapid advance in equity markets could be over. Markets may now be plateauing from the steep trajectory of the "recovery stage" and moving to a "normal stage" of performance and behavior. Stock prices may need to wait for the economy and corporate profits to catch up with recent gains. The equity markets were not good predictors of the credit market crisis, but they seem to be more accurate than many experts at predicting the pace of the current recovery.

After making small adjustments to our tactical equity allocations during the last four months, we have worked since the end of the year to rebalance many accounts. Where the recovery had pushed accounts into overweight equity positions, we are taking profits to get back to individual client targets.

We've also been modifying our bond allocations. In our October letter we expressed concerns about the bond market. Although we expected the Fed to keep short-term rates depressed for a while, we were afraid that quantitative easing by the Fed and excessive demand for bonds by retail investors had caused various areas of the fixed income markets to become overvalued. At the time, many experts were referring to a "bond bubble."

During the quarter, the bond markets acted to release some air from the bond bubble. The 10-year U.S. Treasury bond, often used as a proxy for interest rates, moved from a low of 2.38% to a year-end yield of 3.34%. Since bond prices move

in the opposite direction of interest rates, a portfolio of these securities would have suffered a loss of approximately 7% during this time frame.

This type of move in interest rates can have many explanations. While many were quick to take the upshift as a negative (i.e. inflation concerns), we agree with the experts who interpreted the bond market's message more as a positive. The bond market seemed to be saying it now believes the U.S. is not heading down the same deflation and stagnation road as Japan; rather, the world economic recovery is obviously proceeding.

Despite the positive interpretation for the U.S. Treasury bond market, interest rates also shifted up for the tax-exempt municipal bond market. The concerns here were mainly about defaults. Tax-exempt bond funds experienced record outflows during the quarter, forcing them to sell billions of dollars in holdings into an already realigning market.

We believe the developments in these two separate markets reflect conflicting opinions about the future for bonds. In the short run, the upshift in bond yields is a good sign, signaling recovery. However, in the longer run, there is considerable concern about how the federal and local governments will be able to cope with the demands of the "new austerity" without triggering a significant bout of inflation that could drive up interest rates well beyond where they are now. The conflict will be influenced by how the Fed drains excess liquidity from the financial markets and by how governments at all levels address budget deficits.

We maintain exposure to the bond market for its income generation and diversification properties; however, we have begun acting to minimize the pain from rising interest rates. In December, we started to realign our bond allocations; focusing on shortening maturities and decreasing exposure to Treasuries. In the process, we also reduced our reliance on the Pimco Total Return bond fund. With assets now exceeding \$250 billion, it had become one of the largest mutual funds in the world, and was an over weighted position in most client accounts. As conditions warrant, we will continue this process.

## **Outlook**

We are pleased that the economic environment has continued to improve and the improvement is being reflected in the markets. However, the dramatic rate of improvement in corporate profits and the effects of economic stimulus must eventually moderate. We believe that is happening now. We do not dispute that the U.S. and other economies face serious challenges that will take years to work through.

While recognizing these challenges, we remain optimistic on the equity markets. There is mounting evidence that we are returning to a more "normal" state. Risk characteristics of the market, such as measured volatility, have dropped for the third straight year. Credit spreads in the bond market have narrowed to more normal levels. We are also seeing a return to normal correlations between individual stocks.

These measurements point to a market that moves in ways more consistent with historical tendencies. Therefore, a general uptrend should continue, but expect moderate pullbacks along the way. These are also signs that the probability of larger swings, as we have experienced over the last couple of years, may be minimized.

During the recovery stage, equities tended to move in lockstep with each other. The range of performance between various equity categories was narrow. This didn't matter so much when all equity values were rising so fast. However, as the market returns to a "normal stage," Summit gains opportunities. The move to "normal" is being accompanied by a widening performance differentiation. The bigger the difference between best and worst performing investment options, the better Summit's chances of adding value for our clients through our tactical changes to the equity mix.

### **Congress Reaches Unexpected Compromise on Income and Estate Taxes**

Congress brought clarity to tax decisions by extending the Bush tax rates another two years. Even bigger news: Congress increased the exclusion limits to \$5 million for the Federal estate tax and also adopted a \$5 million limit for lifetime gifts. Furthermore, an unused exclusion by the first spouse to die is "portable" for use by the remaining spouse. For years, many clients postponed re-evaluating their wills and estate plan to wait and see what Congress did with the estate tax rules in 2010. Congress has now acted. There are new financial planning opportunities with the new laws and there are pitfalls for those who fail to plan.

### **Tax Season Begins: Realized Gains and Losses Reports**

A good year for the markets inevitably results in more capital gains. For most clients' taxable accounts, we have enclosed 2010 Realized Gains & Losses reports along with 4<sup>th</sup> quarter performance reports. *Please keep these with other tax documents you provide to your tax preparer.* If you have any questions about the Realized Gains & Losses reports, or would like us to also send a copy to your tax preparer, just let your Summit advisor know.

Thank you for your faith in us, and as always, please contact us if you have any questions.

*Summit Asset Management LLC*