

Economic & Market Review

~ Year End 2010 Investment Newsletter ~

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Executive Summary

The year began with investors wondering when and how stimulus measures would be lifted. Debate focused on how economies and the capital markets would fare in the absence of various expansionary initiatives. How things can change in 12 months. As the year drove to conclusion, contemplation of exit strategies was no longer even on the radar screen. As a matter of fact, governments remained hard at work identifying and structuring new supportive, if not expansionary, programs. In the end a second generation of monetary and fiscal measures, not to mention bailout funds, have been established to replace the waning or expired initial set. For the U.S., Europe, and Japan, it seems talk of exit strategies is premature.

One cannot argue with results. Indeed, if the capital markets are the report card for economic developments, lawmakers, regulators, and central bankers made the honor role. Domestic equities, real estate, commodities, and high yield bonds all delivered solid returns.

Although results were good, the year's path was neither straight nor devoid of obstacles. Sovereign debt issues in Europe flared up repeatedly with both Greece and Ireland requiring bailouts. A \$1 trillion rescue fund was established for such a purpose. It remains to be seen if this will be sufficient to handle potential problems in Portugal, Spain, Italy and other embattled euro-zone countries. More importantly, adding debt on top of debt provides short-term relief but no long-term solution. Excessive sovereign debt and

unfunded liabilities must eventually be dealt with and the prognosis is not good.

The domestic economy had its share of headaches as GDP growth slowed in the middle of the year, the labor market remained stalled, and housing began a second downward slide.

By late summer, the world needed a good booster shot in the arm. As it did during the depths of the financial crisis, the Federal Reserve came to the rescue. The monetary policy initiative they conceived in August served as a keel to right the ship for the remainder of the year. QE2, as it is called, is a second round of easing whereby the Federal Reserve will purchase up to \$600 billion in Treasury securities through the first half of 2011.

After waking up from the hit they took in November, the legislative community in Washington followed the Fed's supportive lead. Specifically, their enactment of favorable tax policies served to eliminate uncertainty and to avoid increased taxes in 2011. This final act drove economists to increase 2011 GDP growth expectations by 0.5% and sealed the year's positive fate.

Investors were justifiably very positive at year-end with investor sentiment metrics indicating a very bullish marketplace. While we can relate to this enthusiasm, we will avoid complacency and be ever mindful of the challenges that lie ahead.

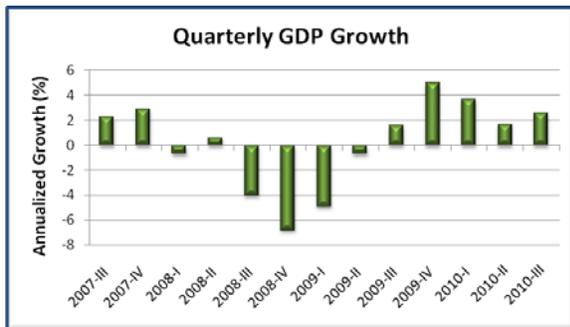


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Economic Review and Outlook

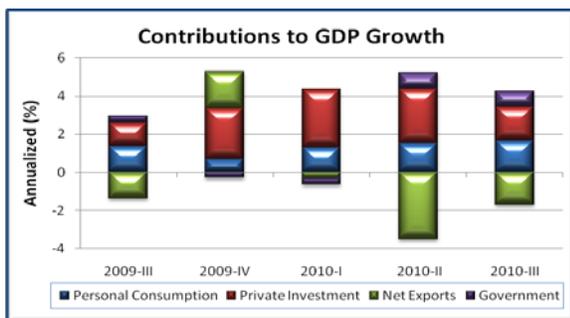
Economic Growth

On an annualized basis, gross domestic product (GDP) grew 2.6% in the third quarter of 2010. As shown below, the U.S. economy has delivered five consecutive expansionary quarters since its emergence from recession in the third quarter of 2009.



Data Source: U.S. Department of Commerce

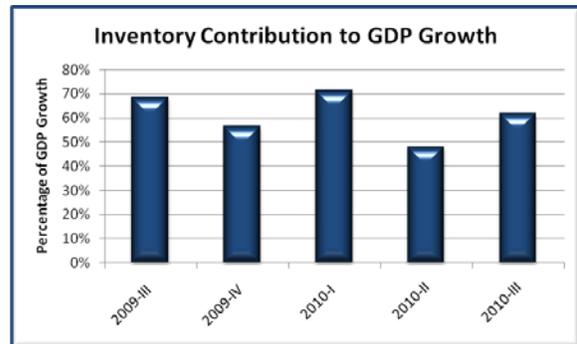
The recession was driven by a decrease in personal consumption and, most particularly, a dramatic decline in private investment. Likewise, the foundation of the ensuing economic recovery has been growth in these same areas (shown in red and blue in the following chart).



Data Source: U.S. Department of Commerce

The impact of inventory changes on GDP growth has been particularly notable. This was the case during the downturn, as inventories were depleted, as well as the recovery, as inventories were replenished.

This rebuilding effort has accounted for nearly all of the growth seen in private investment and, as shown below, over 60% of total GDP growth over the previous five quarters.



Data Source: U.S. Department of Commerce

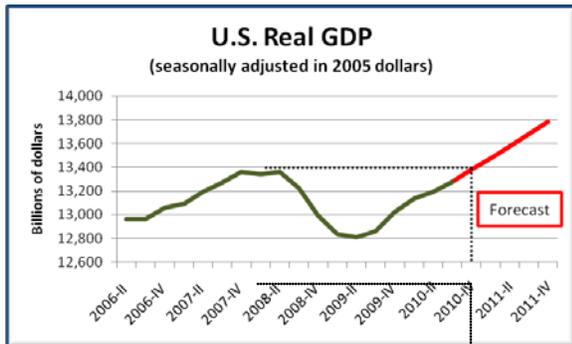
Why the focus on inventory? Inventory adjustments are cyclical in nature. For all practical purposes, they represent a byproduct of economic activity rather than a sustainable engine of growth. As a result, the inventory related component of GDP growth will necessarily wane in coming periods. As this takes place, other elements of the economy must take up the slack.

As the year drew to a close, investors received new assurances that the economy was indeed being primed for sustained, if not accelerated, growth. In particular, key positives included:

- Tax Relief – New tax cuts along with a delay of impending tax increases
- Monetary Stimulus – A second round of quantitative easing initiated by the Federal Reserve
- Governance Changes - Hope for improved direction and priorities as midterm elections led to sweeping changes in government leadership



The culmination of these events, along with generally improving economic releases in recent months, led economists to increase growth projections for the fourth quarter of 2010 as well as for the coming year. Should these forecasts prove accurate (3.0 – 3.5% growth for the periods mentioned), economic output will have completely recovered from the recession by year-end 2010.



Data Source: U.S. Department of Commerce

The economic big picture has clearly improved. The aforementioned fiscal and monetary policy decisions are supportive of economic growth and government leadership seems to appreciate their new mandate.

Despite the positives, this is a bifurcated economy. Achieving new GDP records provides little solace to the 4 million households at serious risk of losing their homes. Payroll tax cuts are meaningless to the 14.5 million unemployed individuals without paychecks. “New religion” may be years late and a few hundred billion dollars short as politicians face what in some cases may be insurmountable fiscal challenges.

Keeping the positives and negatives in mind, the remainder of this newsletter reviews the economy in an effort to provide

a more granular view of the strengths, weaknesses, opportunities, and threats that lie ahead.

The Consumer

Despite economic, employment and housing challenges, the consumer has demonstrated favorable trends in many economic metrics.

The personal savings rate jumped during the recession, reversing a multi-decade downward trend. Although the economy has been in recovery for over a year, the savings rate appears to have stabilized at a new, higher level of about 6%. Although this is somewhat below the pre-1980s range of 8 – 10% (see chart), it provides the consumer with greater financial flexibility, a stronger balance sheet, and an improved ability to meet financial commitments.



Data Source: U.S. Department of Commerce

Resulting notable consumer financial improvements include:

- Total household debt has declined for an unprecedented 9 continuous quarters to the tune of \$671 billion.
- Credit card delinquencies are back to pre-recession levels and charge-offs are trending down.



- Consumer loan delinquencies are trending down and charge-offs are at pre-recession levels.
- The percentage of disposable personal income needed to meet fixed financial obligations (the “financial obligations ratio”) has declined dramatically. Of note, the current level was last witnessed in the mid 80’s and early 90’s.

Fortunately, there is more to the consumer story than fiscal restraint. Retail sales increased sequentially in eight out of the first ten months of 2010. Year-over-year growth averaged 6% during this time period and the most recently reported level of total retail sales (shown below) was within easy reach of the all time high.



Data Source: U.S. Census Bureau

If the consumer appears on the right track, one might logically ask why the recovery has been so lackluster compared to previous post-recession periods. The answer lies not in the direction of consumer behavior, which does appear correct, but rather in the magnitude of that behavior.

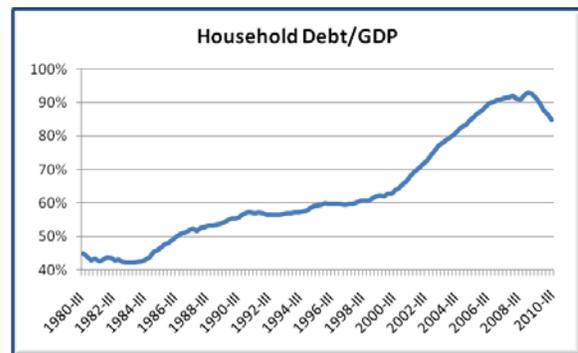
The average growth in personal consumption expenditures during the past five quarters has been 1.9%. That is quite meager compared to the 3.4% average

growth in consumption during the past 50 years.

And, while this is of concern, it still does not tell the entire story. An even more appropriate comparison is to evaluate consumption growth during the same time period of previous economic cycles.

Including the recent financial crisis, there have been 11 post World War II recessions in the U.S. The average consumption growth in the five quarters following previous recessions has been a fairly impressive 5.1%. Compared to that, the recently experienced 1.9% growth is not just meager, it’s downright miserly.

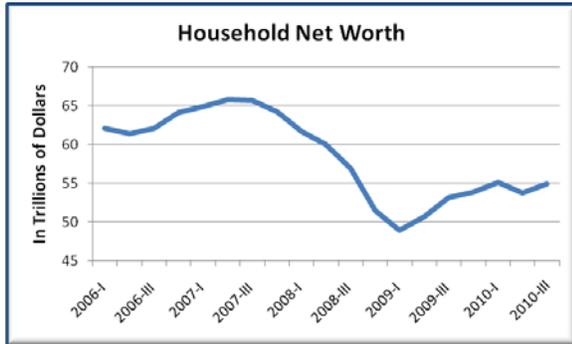
Considering consumers accounts for 70% of total U.S. GDP, it is not feasible to expect strong, sustainable growth without them fully engaged, if not leading the charge. The impediments to an engaged consumer are jobs, housing, debt, net worth, and confidence. The labor market and housing are weak and will be considered in more detail later. Debt, despite moving in the right direction, remains exceptionally high relative to GDP.



Data Sources: U.S. Department of Commerce & Federal Reserve

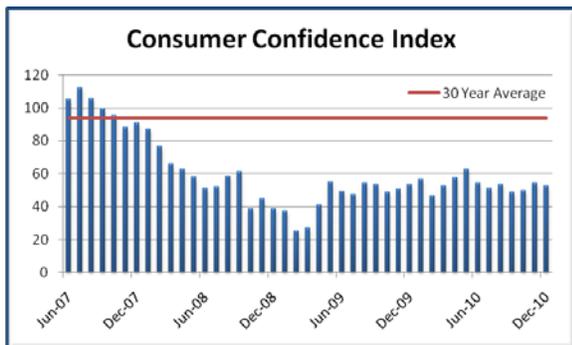


Household net worth is still down 17%, or \$10.9 trillion, from the peak.



Data Sources: U.S. Federal Reserve

Consumer confidence, which flows largely from the previous items, remains extraordinarily low. Undoubtedly, the psychological scarring from the financial crisis has also weighed on consumer sentiment.



Data Sources: The Conference Board

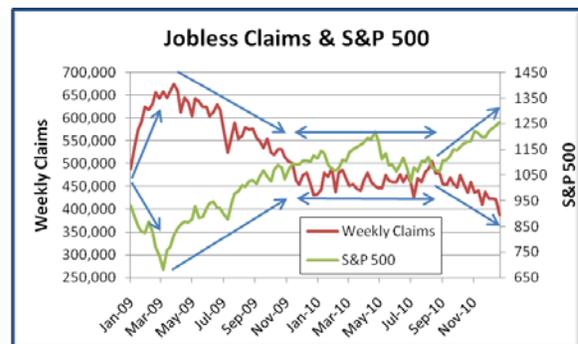
Positive developments in these key metrics will help drive favorable consumer behavior. Favorable consumer behavior, in turn, will be necessary to achieve expected growth in 2011.

Employment

After showing significant improvement in 2009, employment metrics largely stalled for much of 2010. During the year, the labor force increased by a subpar quantity, the participation rate continued to decline, the percentage of the population working

remained at the recession's low, the average length of unemployment expanded to 34.2 weeks, and payroll growth averaged an insufficient 94,000 jobs per month. While some progress was made on the unemployment rate, which fell from 9.9% to 9.4%, this was more a reflection of discouraged workers leaving the labor force than the creation of new jobs.

Despite the generally lackluster, if not disappointing, progress on jobs, an interesting phenomenon we have commented on in the past continued to hold throughout the year. Specifically, the stock market shows a tight, inverse correlation with jobless claims. As illustrated in the following chart, rising jobless claims correspond to stock market declines. In periods where no material change in jobless claims is observed, stocks are flat. Finally, as jobless claims fall, the stock market is off to the races.



Data Sources: U.S. Department of Labor & Yahoo! Finance

Several conclusions can be drawn from this relationship.

- As a discount of future activity, the stock market is indicating how critical jobs are to the economy.
- Paying attention to jobless claims, and forecasting the metric, may add value to the asset allocation process.

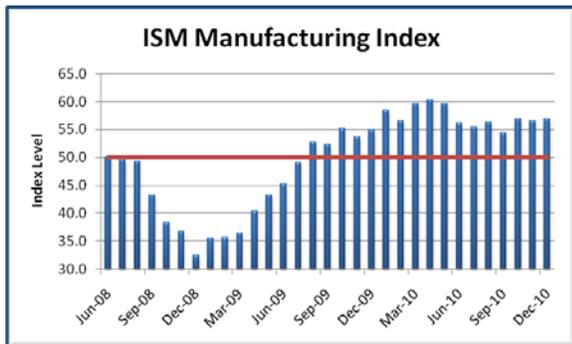


- Still elevated jobless claims suggest further stock market gains may be in store as this valuable metric continues to work its way down to more normal levels.

Looking forward, we expect healthier employment trends to emerge in 2011. Loan growth turned positive toward the end of 2010 and reports suggest the financing market for small companies is starting to thaw. Providing capital to these entities will be important for job creation. Large companies, for their part, are becoming more amenable to hiring and have the balance sheet strength to do so. The necessity to hire is also evident as average weekly work hours are back to prerecessionary levels. Little slack remains to squeeze more from existing workers. Lastly, while the unemployment rate may tick down, most expect the metric to remain above 9% throughout 2011 and to remain elevated for several years.

Manufacturing

Manufacturing emerged as a bright spot toward the end of 2009 and the sector continued to shine throughout 2010. The Institute for Supply Management's Manufacturing Index has consistently registered expansionary readings over the past 17 months.

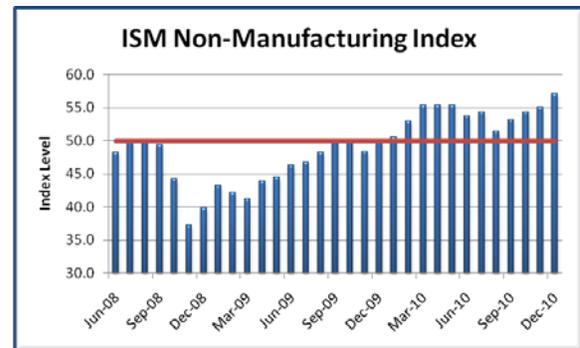


Data Source: Institute for Supply Management

Industrial production and capacity utilization moved positively during the year albeit at declining rates for each. The three month moving average of industrial production ended the year near flat line and capacity utilization, currently 75.2%, has found further gains challenging over the past four months.

Service

In contrast to the manufacturing sector, which appears a bit weary, the service sector accelerated into year-end. This is particularly encouraging for the domestic economy as service accounts for over 86% of jobs and a comparable level of economic output.



Data Source: Institute for Supply Management

Real Estate

Herculean efforts by the government enabled housing to stabilize in the latter half of 2009 and the first few months of 2010. As indicated at this time last year, we were far from convinced that housing could stand on its own without government crutches. These supports, namely Federal Reserve investments in the mortgage debt market and tax credits for home buyers, expired in March and April, respectively. Immediately following the completion of those programs, deterioration was seen in industry metrics such as home prices,



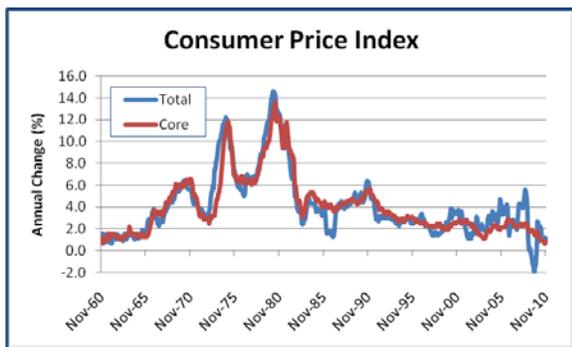
existing and new home sales, and inventory levels relative to sales. In the three months following the end of government support, nearly every market tracked by Case-Shiller was in decline – a complete reversal from earlier in the year. Through August, home prices had already dropped over 3% since April.

Observing the level and pace of deterioration, by year-end many investors and economists grew increasingly concerned about the outlook for housing. Considering the number of underwater mortgages, foreclosures in the pipeline, homeowners in serious delinquency, the recent rise in mortgage rates, and a marketplace bursting with inventory, concern is certainly understandable.

Inflation or Deflation

Developed economies across the globe are working to avoid deflation while emerging markets are increasingly seeing signs of inflationary pressures.

The U.S., with inflation at a 40+ year low, is not immune to this dichotomy (see below).



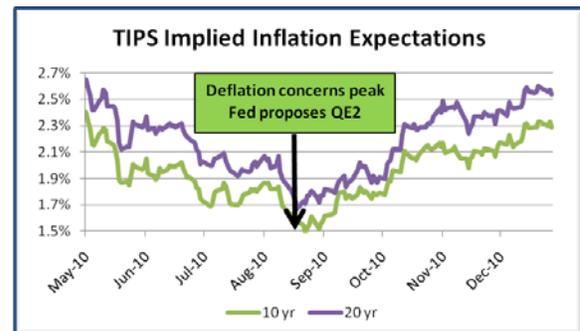
Data Source: U.S. Department of Labor

To this point, as the pace of economic recovery slowed during the summer, investors became acutely concerned about

deflation. Economic slack and de minimis inflation added fuel to the fire.

At the time, the Federal Reserve acknowledged the detrimental impact deflation has on an economy, but saw very little risk of deflation occurring. Despite this public stance, the Fed hatched a plan to guard against deflation. This insurance policy of sorts, commonly referred to as QE2 (Quantitative Easing Part 2), was introduced to the world in August. The concept was incredibly well received, deflation discussions disappeared, and the capital markets never looked back.

The following chart uses the nominal and TIPS yield curves to back into implied inflation expectations. It is perhaps the best way to illustrate the reversal.



Data Source: U.S. Treasury & Summit Calculations

The period from May through August encompassed the height of the European debt crisis, the “flash crash,” slowing global growth, and accelerating fears of deflation. As shown, inflation expectations declined by about 1% during that time. Following the Fed’s discussion of QE2, inflation expectations rapidly adjusted back to previous levels.



The previous discussion provides a number of valuable insights to help formulate go-forward expectations.

- The Fed continues to be aware, creative, and nimble in strategy deployment.
- Investors have demonstrated strong confidence in the Fed's ability to assist, if not manage, the economy.
- Inflation expectations are back in the Fed's sweet spot (i.e. not flashing risk in either direction).

The Government

The economy provided a roller coaster of sorts for policymakers during the year. A reasonably strong start and an outstanding finish provided the bookends for mid-year challenges.

The second quarter was the main problem child as sovereign debt risk and slowing domestic and global growth required intervention. Greece required a financial rescue package early in the year while Ireland required the same toward year-end. As the year progressed, the challenge of U.S. growth and deflation was initially met by the Federal Reserve. This was followed closely with a fiscal response to delay tax increases as well as initiate new tax cuts and incentives. In the end, a full suite of new monetary and fiscal tools were deployed. In effect, these replace previous initiatives that have either concluded or will do so shortly. If the capital markets serve as the arbiter of policy effectiveness, lawmakers and central bankers hit the ball out of the park in the final months of the year.

The policy destination was effective, but economic pressures and mid-term elections made for a rough political ride to get there. Following November elections, politicians demonstrated a more genuine interest in bipartisan cooperation and the final weeks of the year proved very productive.

Monetary Policy

Early in the year, the Federal Reserve discontinued a number of emergency liquidity programs and completed the acquisition of over \$1.5 trillion in Treasury, agency, and mortgage backed securities. To avoid unintentional monetary tightening, a follow-on decision was made to reinvest proceeds from maturing investments back into U.S. Treasuries. Last, but certainly not least, after two months of discussion, a second round of quantitative easing was born in November. This program envisions the purchase of \$600 billion in Treasury debt through the first half of 2011.

Fiscal Policy

Throughout the year, global policymakers engaged in a debate over stimulus versus austerity. The U.S., in agreement with the OECD, believed governments needed to provide more stimulus and/or delay plans for budget cuts. Europe, siding with the IMF, was hell bent on austerity.

Legislative Action

Interesting if not consequential legislative events during the year included:

- Passage of health care reform
- Passage of financial reform
- Collapse of the climate bill
- Passage of the tax bill to delay expiration of Bush tax cuts and provide other tax relief and incentives



Capital Markets Review and Outlook

Overview

The first eight months of the year brought turbulence and uncertainty to the investment markets. A series of capital market booms and busts ensued as investors digested seemingly nonstop positives and negatives that whipsawed the market.

Returns were positive for the first quarter, but investors were concerned over European budget deficits, an unsettling political climate in the United States and China's actions to restrain stimulus measures.

Strong gains at the start of the second quarter gave way to dramatic declines. The "pro-growth" trade unwound in a dazzling display of flight out of risk assets and into the security of traditional safe havens – gold, U.S. Treasuries, and the dollar. By the end of the first half, stocks were significantly in the red with foreign currency exposure accentuating declines.

Earnings-induced equity market strength in July gave way to U.S. macro challenges in August. At the same time, investor concerns regarding European sovereign debt diminished following release of benign European bank stress tests. Seemingly in the blink of an eye, the U.S. and Europe traded places between the penthouse and the doghouse. U.S. equity market weakness ensued, the dollar came under pressure,

and investors began to fear U.S. deflation. By quarter end, the 10-year Treasury yield had dropped to levels last seen during the height of the financial crisis. The marketplace was schizophrenic!

In the end, it was the Federal Reserve that provided much needed clarity and direction for the markets. Ben Bernanke's suggestion, in August, of a second round of

quantitative easing proved to be the defining event of the year. The markets never looked back. Commodities and equities rocketed higher. The fear of deflation died a quick death and inflation expectations climbed. By year-end, fixed income yields had

risen and bond investors experienced their first quarterly losses of the year.

In retrospect, the capital market impact of QE2 should not be surprising considering it was the first round of quantitative easing that provided the launch pad for risk assets in the depths of the financial meltdown.

Equity Markets

The S&P500 index delivered 10.8% for the final quarter and 15.1% for the year. For the year, small and mid capitalization securities materially outperformed large while growth stocks edged out value.

	4 rd Qtr 2010	Full Year 2010
U.S. Treasury Bills	0.0%	0.4%
Barclays Aggregate Bond	-1.3%	6.5%
Barclays Municipal Bond	-4.2%	2.4%
S & P 500	10.8%	15.1%
Dow Industrials	8.0%	14.1%
MSCI EAFE (Int'l Equities)	6.6%	7.8%
DJ UBS Commodity Index	15.8%	16.8%

Data Source: Morningstar



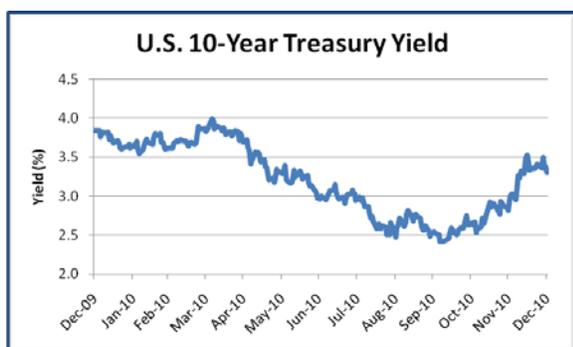
International equities, as represented by the MSCI Developed Markets index, returned 6.6% for the quarter and 7.8% for the year. Emerging markets rose 7.3% for the quarter and 18.9% for the year.

Although the dollar gained versus the euro, its weakness against other currencies provided a net benefit to dollar based investors. Currency adjusted returns were 2.9% and 4.8% higher for developed and emerging markets, respectively.

Fixed Income Markets

The Barclays U.S. Aggregate Bond index was down 1.3% for the quarter and finished the year with a gain of 6.5%. Global fixed income markets had nearly identical returns for the comparable periods.

Despite fairly wild intra-year fluctuations, the 10-year Treasury yield ended at 3.3% versus its starting level of 3.8%. The Treasury yield curve remains historically steep and consensus expectations are for the 10-year Treasury to end 2011 with a yield of 3.5%.



Data Source: U.S. Treasury

The credit side of the market performed well with the high yield index gaining 3.2% for the quarter and 15.1% for the year. Corporate bonds outperformed mortgages and mortgages outperformed Treasuries.

During the fourth quarter, unique challenges to the municipal securities market led this segment of fixed income to underperform. Specifically,

- Legislative extension of the Bush tax cuts diminished the value of, and need for, tax advantaged investments such as munis.
- The year-end termination of the popular Build America Bond program will force state and local borrowers to meet financing needs in the traditional tax-free muni space, thus increasing supply.
- Various federal support programs are winding down and will increase fiscal pressure on state and local governments.
- The financial health of some issuers has declined in the aftermath of the fiscal crisis. The resulting decline in credit quality forces yields up as investors demand compensation for higher risk.

The municipal category was down 4.2% for the fourth quarter resulting in a total annual gain of 2.4%.

Alternative Assets

Anticipating inflation and dollar weakness from U.S. fiscal and monetary policies, investors pushed into inflation safe havens such as commodities, gold and precious metals, real estate, and Treasury Inflation Protected Securities (TIPS). Interestingly, REITs (real estate investment trusts), despite ongoing fundamental challenges, performed exceedingly well.



For the year, commodities were up 16.8%, gold rose 29.8%, and REITs delivered 26.9%. Agricultural commodities were very strong with corn, wheat, soybeans and coffee rising anywhere from 30% to nearly 80% by year-end.

As a category, hedge funds performed modestly during the year. Fixed income strategies, long biased equity hedged funds, macro managers, and those with a multi-strategy mandate performed best. Some market neutral, short biased, and merger arbitrage managers were challenged. The managed futures category delivered just over 6% for the year.

Looking forward we cannot help but notice that the level of investor complacency appears high. Popular investor sentiment indicators, listed below, are flashing caution and are worthy of attention.

- The put/call ratio is at a multi-year low categorized as “Bullish Extreme.”
- The latest Investors Intelligence Survey shows that 57% of investors

are bullish while 19% are bearish. This spread between bulls and bears is high and corresponds to the market peak in October of 2007.

- The market’s “fear gauge”, the VIX, is near a multiyear low.



Data Source: Yahoo! Finance

Although we may not be as far out of the woods as these indicators portray, the capital markets did end the year on a high. Likewise, economic developments and policy initiatives have been encouraging and economic growth appears to be self sustainable.



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