



2011: A Fourth Quarter Review

A quick summary of economies & markets for you.

It may have been a frustrating year on Wall Street, but the fourth quarter of 2011 was a real turnaround from the third. However, the stock market still ended up having a subpar year, a performance that hopefully won't be repeated in 2012. Here is a look at some of the big news items of the quarter, and at some of the improved economic indicators that investors noticed.

The quarter in brief. The S&P 500 soared 11.15% in 4Q 2011 to dodge a bear market and end the year virtually flat. Key commodities ended the year nowhere near their spring peaks. Inflation and unemployment declined, and housing appeared to offer discernible hints of a rebound. Capitol Hill bickering may have irritated Main Street, but it didn't take the enthusiasm out of the consumer during the holiday season. Europe faced a real possibility of recession as two prime ministers resigned and the European Union risked fracture under the burden of its collective debt crisis. Yet the quarter ended with consumer (and investor) sentiment seemingly improved in America.¹



Domestic economic health. As the quarter unfolded, the news got better. September's jobless rate was 9.1%; November's jobless rate was 8.6%, the lowest level of unemployment since March 2009. By November, annualized inflation was lower at 3.4% after the Consumer Price Index declined 0.1% in October and stayed flat in November.^{2,3}

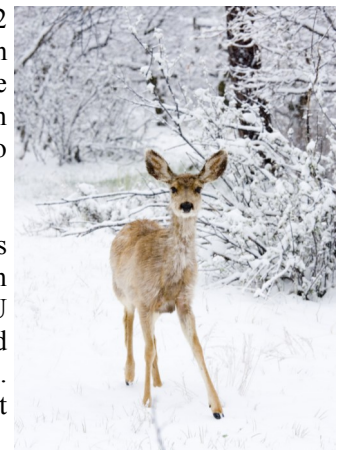
The Bureau of Economic Analysis said consumer spending rose by (a revised) 0.4% in October and just 0.1% in November. Overall U.S. retail sales also notched monthly gains: the Commerce Department measured a 0.6% rise in October and a 0.2% gain for November, and private industry surveys hinted at strong shopping over the holiday season. On December 15, the National Retail Federation revised its sales growth forecast for November and December upward to 3.8%.^{4,5,6}

The two most-watched consumer confidence indices appeared to make strides toward pre-recession levels (though there was still a long way to go to get to them). The Conference Board's index, just 40.9 in October, climbed to 64.5 in December. The final December University of Michigan consumer sentiment survey rose 5.8 points to 69.9, beating the expectations of economists surveyed by Bloomberg News and pulling above the average reading of 64.2 recorded during the 18-month recession.^{7,8}

The Institute for Supply Management's manufacturing PMI increased in each month of the quarter, ending at 53.9 in December. ISM's service sector index slipped from 52.9 in October to 52.0 in November. Commerce Department data showed overall durable goods orders rising 3.8% in December (thanks to a leap in aircraft orders) after a (revised) flat reading for October.^{9,10,11}

In Congress, the quarter was notable for two developments. The "super committee" of 12 legislators assigned to come up with a deficit reduction plan failed, triggering \$1.2 trillion in involuntary cuts to the federal budget in 2013, including major cuts to defense spending. Later, Republicans and Democrats reached a compromise and passed an extension of the payroll tax holiday, long-term jobless benefits and Medicare payments to physicians at the current level through February 29.^{12,13}

Global economic health. The quarter passed without Greece defaulting, but new fears about Italy seized the headlines. In October, there was a collective sigh of relief when German chancellor Angela Merkel and French president Nicolas Sarkozy talked EU banks into boosting capital ratios and accepting 50% writedowns on Greek bond holdings. There was also a vow to increase the size of the Eurozone bailout fund. However, Italy (the EU's number three economy) was running a \$2.7 trillion deficit that amounted to 120% of its GDP.¹⁴



By year's end, Italian prime minister Silvio Berlusconi had resigned, and Greece's George Papandreou had also stepped down, the euro had fallen 5.6% against other benchmark currencies in the past six months, and there were new anxieties over capital ratios at major Spanish and Italian banks. EU inflation was down to 2.8% in December, but the key Markit purchasing managers index was below 50, indicating manufacturing sector contraction. Economists speculated that the Eurozone was on the edge of a recession (if not already in one) and worried about the future of the EU and the euro.^{14,15} Early in the quarter, economists also mulled whether manufacturing was slowing down worldwide. By December, some key PMIs seemed to refute that notion. Purchasing manager indices improved last month in the United Kingdom, China, Australia, India, Switzerland and Singapore, complementing the rise in the U.S. ISM manufacturing index.¹⁶

World markets. Mirroring what happened in America, some global benchmarks had a good quarter to take some of the sting out of a lousy year. Here is the fourth quarter performance of key indices in U.S. dollar terms, as measured by Morningstar: Sensex, -6.07%; CAC 40, +5.96%; DAX, +7.20%; FTSE 100, +8.65%; Hang Seng, +4.99%; Nikkei 225, -2.82%; All Ordinaries, +1.36%; TSX Composite, +2.85%; Shanghai Composite, -6.77%. All these indices ended down for 2011, from mildly down (the FTSE at -5.55%) to way down (the Sensex at 24.64%). The MSCI World and Emerging Markets indices, made an improvement from the previous quarter. The World Index gained 7.11% to finish 2011 at -7.61%; the Emerging Markets rose 4.08% but still finished the year at -20.41%.^{17,18}

Commodities markets. Metals by and large retreated in the quarter. Gold fell 3.4% on the COMEX in 4Q 2011, its first quarterly setback since 4Q 2008. Silver logged its third straight negative quarter, going -7.2%. Platinum lost 7.8%, but palladium gained 6.8%. Gold advanced for the eleventh straight year (+10.18% to \$1,565.80 per ounce). The same could not be said for silver (-9.8%), copper (-22.7%), platinum (-21.0%) or palladium (-18.3%).^{19,20,21}

As for energy and crop futures, oil rose only 8.15% for 2011 after two years of astonishing annual gains. A strong fourth quarter helped: NYMEX crude rose an eye-popping 24.8% in the last three months of the year. Crude prices ended 2011 at \$98.83 a barrel. (Oil gained 121.6% across 2009-2011.) Natural gas limped to the finish line again (-32.2% in 2011) and wheat (-17.8%) and cotton (-36.7%) also suffered big 2011 setbacks. The U.S. Dollar Index finished the quarter with a +2.6% December to go +1.6% for the year.^{20,21}

Real estate. The National Association of Realtors said existing home sales rose 4.0% in November; the sales pace was at its highest since January. The Census Bureau said new home purchases increased by 1.3% in October and another 1.6% in November. Housing starts, down 2.9% in October, soared 9.3% for November. NAR also noted that pending home sales rose 7.3% in November (and they were up 5.9% annually). On the downside, October's S&P/Case-Shiller Home Price Index showed a 3.4% annual existing home price decline across 20 metro markets, but the lower prices were perhaps one factor stimulating homebuying.^{22,23,24,25,26}

Average interest rates on 30-year home loans ended the 4Q almost unchanged; average rates on other types of mortgages decreased. Freddie Mac's Primary Mortgage Market Survey tracked the following movement (September 29-December 29): 30-year FRMs, 4.01% to 3.95%; 15-year ARMs, 3.28% to 3.24%; 5-year ARMs, 3.02% to 2.88%; 1-year ARMs, 2.83% to 2.78%.²⁷

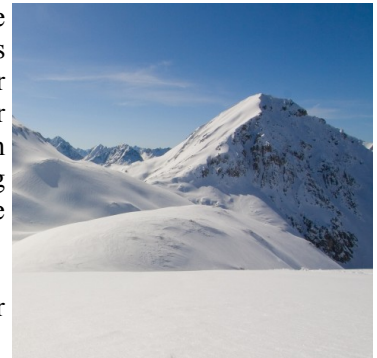
Looking back ... looking forward. The Dow and S&P 500 both had their finest quarters since 3Q 2009. Considering how bleak things looked in the EU during the last few months of 2011, these terrific 4Q performances attest to the resilience of the market.¹

% CHANGE	2011	4Q CHG	1-YR CHG	10-YR AVG
DJIA	+5.53	+11.95	+5.53	+2.19
NASDAQ	-1.80	+7.86	-1.80	+3.36
S&P 500	-0.003	+11.15	-0.003	+0.95
REAL YIELD	12/30 RATE	1 YR AGO	5 YRS AGO	10 YRS AGO
10 YR TIPS	-0.07%	1.08%	2.41%	3.50%

Sources: cnbc.com, bigcharts.com, treasury.gov, treasurydirect.gov - 12/30/11^{1,28,29,30}
Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.
These returns do not include dividends.



As we enter 2012, the big question is whether U.S. equities can manage an advance given that it may take several quarters (or even several years) to settle the Eurozone's sovereign debt crisis. Optimists think that even if Europe slips into recession, our economy will be robust enough to avoid another one. Pessimists see potential for another global slowdown, a drawn-out and possibly fractious effort to mop up debt in the EU and tepid growth in key Asia-Pacific economies and various emerging markets. Volatility seems a sure bet, and patience may be a virtue. It promises to be an interesting (and hopefully, a less momentous) first quarter.



In April, we'll send you a first quarter recap. Should you have financial questions or concerns in the meantime, please feel free to contact the office.

Sincerely yours,

Lars Knudsen and Dan Stober

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