Investment Review | 2011

A detailed commentary on 2011, along with insight and an outlook from Market Street's investment team.

OVERVIEW

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2011 was another tumultuous year in the financial markets, providing a great deal of angst but very little return. The S&P 500 started the year at 1,257.64 and ended at 1,257.60 (this is not a typo) for an annual price gain of 0%. Add in dividends and investors made a measly 2%, less than the rate of inflation. Maybe an investor should be happy with this, as according to MSCI, the S&P 500 was the third best performing developed country stock market (behind Ireland and New Zealand) and the fifth best stock market in the world (behind Qatar and Indonesia)! The MSCI All Country World Index, excluding the U.S., fell about 14%, with emerging market equities down over 18% year to date. The big winner for the year was bonds, especially U.S. Treasuries. With Treasury bond (10 and 30 years) yields falling more than 1.40% (bond prices are inversely related to yields, so when yields fall, prices rise), intermediate Treasury portfolios returned around 10%. Municipal bonds also did fairly well, with the Barclays Capital 1-10 Year Municipal Index returning 7.6% for the year.

Entering 2011, we believed that many of the economic issues plaguing the global markets had yet to be seriously addressed or corrected. Chief among those were unsustainable government deficits. Unfortunately, the debt burdens in Europe were not (and still have not been) effectively addressed, leading the markets to be overwhelmingly influenced by macroeconomic and headline events. In fact, 2011 could probably be labeled the "Year of Macro Events." Just to name a few:

- Euro Debt Crisis (continued from 2010)
- Arab Spring (geopolitical tensions leading to commodity inflation)
- Japanese earthquake/tsunami/nuclear disaster
- U.S. Credit Downgrade
- U.S. Super Committee failure

These events overshadowed some good corporate fundamentals. Morgan Stanley Research estimates U.S. corporate earnings increased at an annualized rate of 17%, but as noted above, the S&P 500 did not budge. With $83 earnings at the start of the year, the S&P 500 was priced at a relatively reasonable 15 times earnings multiple.

Display 5 Source: Bloomberg/Nautilus Capital Research

At Market Street, our goal is to build the highest quality portfolios for our clients to provide the opportunity for capital appreciation, but significantly preserve assets on the downside. As we look ahead, we would love to tell you that markets are in great shape and big returns are on the horizon. Unfortunately, we see too many risks and not enough opportunity over the next year to currently change client positioning. If history is any lesson, most secular bear markets last a minimum of 15 years (see Display 5). 2012 is the beginning of the 13th year of the current secular bear market. Many unresolved issues remain, which we believe will take the balance of 2012 and plenty of 2013 to address. In the meantime, we may see surprisingly strong periods as short term surprises move markets. Ultimately though, we believe we are in for continued volatility over the next several years, with modest returns at best.

As always, please feel free to contact us if you would like to discuss Market Street's investment program.

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