

The Stock Market

While not one to wish time away, I must admit to being happy about putting 2011 in the rear view mirror. Amazingly the S&P 500 ended up just about where it started the year, but the market had a decade worth of volatility and price moves inside of one year, really just the last six months (more on this in the quarterly letter). As we highlighted what might occur in our last commentary after a deplorable third quarter, the equity markets bounced back in the most recent three month period ending December 31, 2011 – the S&P 500 and Russell 1000 Growth indices ending up +11.8% and +10.6%, respectively, including dividends. Small-caps, as measured by the Russell 2000 Index, jumped +15.5% for the quarter, beating the S&P 500 for the first time in three quarters. The European sovereign debt crisis continued to weigh on overseas indices with developed markets rising just +3.4% for the quarter (as measured by the EAFE Index). Emerging markets fared just slightly better, rising +4.4% for the same period (using the MSCI Emerging Market Index). The streak of domestic equity markets outperforming emerging markets is now five quarters and counting. Year-to-date, the S&P 500 ended up +2.1%, thanks entirely to dividends as the closing price of 1257.60 was nearly identical to the beginning of the year mark of 1257.64 (is that the Twilight Zone music I hear playing?)

With the market rebound, sector performance rotated again back toward cyclical sectors, with Energy leading the way up over +17%, followed by Industrials and Materials, both rising over +15%. The defensive areas of the market, last quarter's leaders, became the laggards with Telecom & Utilities rising around +8%. Consumer Discretionary, Financials and Consumer Staples were in the middle of the pack posting returns ranging from +10% to +13%. Technology stood out as a cyclical sector that did not participate as much in the rally, trading up just under +9% for the quarter. Regardless of this recent cyclical bounce, for the year, defense ruled the day with Utilities, Consumer Staples & Healthcare taking the top three spots, each up over +12%. Despite a decent fourth quarter rally, Financials took last place, falling over -17% for the 12-month period ending December 31, 2011.

Enough about 2011, let's look forward into 2012. The end of the Mayan calendar notwithstanding, we believe 2012 could turn out to be a decent year for equities.

With a recession in the U.S. off the table (for now), the market's attention will focus squarely on several key issues – Europe and its impact on the global economy (esp. Asia), the elections here in the U.S. (and abroad), and finally on corporate earnings. On this last point, we believe that earnings estimates will likely have to come down further to reflect the reality of slower growth abroad, even while recent domestic economic data point to an acceleration here. With the Presidential election in mind, 2004, 1996 and 1992, may be good proxies for how the market trades in 2012 – that is sideways until we gain some clarity on who the eventual winner will be.

The Bond Market

The yield on the 10-Year Treasury Note was little changed from the end of the 3rd quarter – ending 2011 at 1.88%. On a total return basis, intermediate bonds outperformed shorter ones by 50 basis points (0.50%) during the 4th quarter. With Consumer Price Inflation at a 3.4% year-over-year rate (or 2.2% when excluding the volatile food and energy components), we view the US Treasury market as being fully valued. Though the rate of inflation may decline in 2012, there is a significant safety premium built into this market. There is also the possibility that the Federal Reserve chooses to engage in another round of asset purchases (Quantitative Easing 3), but the first two resulted in higher rates in the months following the announcement.

Corporate Bonds outperformed Treasuries for the quarter though there were many differences in individual company performances. At the sector level, the Industrial and Utility sectors remained strong performers while the Financial sector continued to trade based on the news out of Europe. Banks with the most international exposure had the widest spreads. High yield bonds recovered from a difficult prior quarter and had their best performing quarter since the 3rd quarter of 2010.

Municipal Bonds ended the year with a solid performance. Fortunately, the claims by some that there would be many defaults amounting to "hundreds of billions of dollars" didn't come to pass. There were, however, a few notable bankruptcies declared, including Jefferson County, Alabama. Additionally, 2011 tax-exempt issuance totaled \$295 billion – the lowest since 2001. Despite their challenges, municipals offer value relative to US Treasuries.

Economic Outlook

The outlook for the US economy and the markets looked promising as we began 2011. Although the pace was slower than previous recoveries, economic growth was improving (GDP grew at a 2.9% pace in the fourth quarter of 2010). Our optimism, however, faded as the year progressed. The earthquake and tsunami in Japan, floods in Taiwan, revolts in Northern Africa and the Middle East, a reigniting of the European debt crisis, and U.S. politics got in the way.

A sovereign debt crisis that seemed isolated to Greece spread quickly, with sovereign interest rates in Spain and Italy surging during the fall. It became apparent that European nations had not done enough to address their rapidly growing debt burden as the risk of default seemed to grow daily. As the crisis spread, the probability of a Eurozone collapse increased. While the crisis has subsided to some degree with increased liquidity measures and coordination between the European Central Bank and U.S. Federal Reserve, the recent Purchasing Manager's Index (PMI) for the Eurozone confirms the fear of a recession – falling to 43 close to the 2009 recession level of 40. By comparison the PMI in the U.S. is 53.9 (Note: a PMI above 50 generally connotes economic expansion while below 50 means contraction). The U.S. and the rest of the world, especially China, need a stronger Europe. Europe is a major trading partner for the United States and is China's largest export market. A recession in Europe will have an impact on worldwide growth.

Politics have also impeded the recovery in the US. The lack of direction from Washington has created an environment of uncertainty. Businesses are profitable and flush with cash, but reluctant to commit their resources. The failure of the government to even address a small portion (\$1.4 trillion) of our total deficit of nearly \$15 trillion was at best irresponsible and could have substantial ramifications for the future. Interest rates will rise as we need to borrow more and more dollars, and if the credit rating of our debt – currently under negative watch – is reduced further, it could result in less worldwide demand for our bonds. Higher interest rates affect spending at all levels and leave less tax dollars to support essential governmental services.

The political gridlock in Washington is both absurd and costly.

Even with all the negative influences, the domestic economy continues to heal. Growth as measured by GDP likely exceeded 3% in the fourth quarter, well above the 1.8% in the previous quarter. There is a great deal of pent-up demand in the system as businesses have delayed hiring and spending resources on capital goods or building inventories to meet demand. Consumers have also been cautious this year and have focused on paying down debt – though early results from the Christmas season are promising. Increased business spending to rebuild inventories could alone add over 2% to GDP this quarter. Housing also appears to be finding a bottom. Housing starts jumped 9% and pending home sales expanded by over 7% in November.

Employment remains the missing ingredient necessary for a more robust and sustained recovery. Recent statistics, however, are getting better. Household employment has increased by over 1.3 million jobs over the last four months - through November - and the four week average of unemployment claims is at a three year low. Hopefully these trends will continue during 2012. Our expectations are that the recovery will continue but at a slow and uneven pace – dominated by headlines out of Europe and the potential outcomes in Washington. After all it is an election year.

	YTD 2011 Total Return¹	52 Week Total Return²
S&P 500	2.11%	2.11%
DJIA	8.38%	8.38%
NASDAQ	-0.79%	-0.79%
RUSSELL 1000	1.53%	1.53%
RUSSELL 1000 Growth	2.64%	2.64%
RUSSELL 1000 Value	0.39%	0.39%
RUSSELL Mid-cap	-1.50%	-1.50%
RUSSELL 2000	-4.17%	-4.17%
MSCI EAFE	-11.67%	-11.67%
MSCI Emerging Market	-18.42%	-18.42%

1) Through 12/31/11

2) 12 Months Ended 12/31/11

Source: Bloomberg

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