Investment Commentary

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Economic Recovery Gains Momentum

But Are Equity Markets Due For A Modest Correction?

Economy – The economic recovery, while still moving forward at a very slow pace, is nonetheless continuing in the right direction. Economic activity is expanding and the latest index of leading economic indicators posted its biggest gain in eight months. Industrial production is up 5.4% year over year, and while capacity utilization still remains below the expansionary level of 80% it has climbed to 75.9%. The fourth-quarter Business Roundtable survey, an association of CEOs from large U.S. corporations, showed 80% of its members expect sales to increase in 2011. Their economic outlook index rose to its highest level since the first quarter of 2006. In the next six months, 45% of the CEOs plan to increase hiring.

Most Major Economic Indicators Point To A Recovering U.S. Economy

The Roundtable members see current economic conditions as still being far from robust, but they do anticipate subdued growth next year with the GDP growing by 2.5%. The greatest concern the CEOs have going forward is the rising price of basic commodities and unknown health care costs. Inflation continues to remain very low. The Bureau of Labor Statistics reported the Consumer Price Index, a key measure of inflation, rose 1.1% over the last 12 months. In fact, the inflation rate is so low many economists are still concerned about the threat of deflation – or falling prices. The Federal Reserve has a target of about 2% rate of inflation per year.

Industrial Production, Corporate Profits, Retail Sales, And Household Wealth Are All Improving

Inflation will probably remain low in the coming year if the economy continues to improve at the current sluggish rate it demonstrated in 2010. Retail sales continue to pick up. November marked the fifth straight month of gain in sales. The latest sales figures rose to their highest level since fall of 2007, the start of the recession. Retail analysts see the trend in increased consumer spending as not only encouraging for merchants, but also encouraging for the overall economy as consumer spending is a big engine of the U.S. economy. Optimism about the U.S. economy continues to improve with the American consumer. The most recent Consumer Confidence Index rose to its highest level in five months. The latest overall index of 54.1 stands in sharp contrast to the record low of 25.3 measured in February 2009. And while confidence remains weak by historical measures, it continues to move in the right direction. Americans got richer in the third quarter even as home values continued to sink. The Federal Reserve's Flow of Funds reported the net worth of households and individuals climbed $1.2 trillion or 2% in the third quarter. The gains were due almost exclusively to a strong recovery in the equities market.

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Equities – As we close in on the end of the fourth quarter, the Dow is up 10% for the year despite a very weak housing market and 9.8% unemployment. We see potential for more than modest gains in the stock market if investors start to chase momentum, but that is when investors should be most cautious. At this point in time, we sense the stock market may be overbought. The current price/earning ratio stands about 13 times future earnings. Historically, this level P/E ratio corresponds with a forward 10 year average annual return of 7.6%. That is nearly 20% less than the historic average return for stocks. The "normalized" P/E ratio would indicate the market is over-valued. Based on the previous 10 year inflation adjusted earnings, stocks currently trade at 22 times earnings vs. the average of 16.35. The Q Ratio (a measure of replacement cost) suggests the stock market is more than 40% over-valued. Also, we feel investor sentiment is too bullish. Currently, 50% of investors are bullish. Historically, that high a level of bullishness or optimism amongst individual investors presages a correction in stock prices. The correction may be moderate unless exacerbated by other issues beyond just valuation.

HISTORICALLY, EXCESSIVE INVESTOR OPTIMISM PRESAGES A CORRECTION IN STOCK PRICES

Presently, institutional investors are becoming skittish. In October of 2009 the measure of institutional investor optimism was 110. The latest survey shows the measure of optimism to have fallen to 85. The falling level of optimism indicates that "big money" institutional investors now find stocks to be less appealing. Keep in mind, none of these indicators are perfect and "over-valuation" can persist for extended periods in stock markets, but when greed begins to overshadow fear in the stock market then smart investors inch closer to the exits.

Employment – November's employment report from the Labor department showed unemployment increased for the first time since August and now stands at 9.8%. The latest data received from individual states reported that payrolls dropped in 28 states and joblessness rose in 21 states.

ECONOMISTS AND LABOR ANALYSTS SEE UNEMPLOYMENT AT 8.5% TO 9.5% AT THE END OF 2011

Many economists predicted very early that the problem of structural unemployment resulting from this deep recession would take years to correct itself. It would appear now that these early predictions were extremely accurate. From the Federal Reserve to a vast majority of labor analysts, the consensus seems to be that a large number of today's unemployed workers will remain out of work for many years to come. A roundtable of labor experts and Wall Street analysts see unemployment as still being between 8.5% and 9.5% at the end of next year. They all forecast it will take from 4 to 7 years before the unemployment rate approaches 5% once again. A majority of the roundtable cited the long-term lack of both residential and commercial real estate construction jobs and the forecasted future layoffs of municipal workers for keeping unemployment high well into the future.

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Hanover Advisors Announcement

Hanover Advisors, Inc. is currently in the process of obtaining enhanced features and reduced fees for your Pershing account(s). We expect to have complete information by the end of January. If you have any questions, please contact Stephen Molyneaux at (770) 392-3998 or (800) 874-5238.

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Housing - The housing sector continues to remain very weak. Beyond the foreclosure mess and a bloated inventory of empty homes, real estate experts now worry about the impact of higher mortgage rates. Some real estate analysts claim the higher rates are already chilling the housing market. Refinance activity has fallen for five straight weeks and the latest data on mortgage applications saw a 5% drop from the previous week. Foreclosures are expected to pick up once again this coming year as lending institutions correct the legal requirements which have forced many lenders to place a moratorium on foreclosures. The most recent nationwide analysis from Zillow reports American homes are expected to be worth $1.7 trillion less in 2010 compared to 2009. The loss is 63% greater than the $1 trillion drop in 2009.

Real Estate Analysts Predict Continued Home Value Depreciation in 2011

The total value lost since the housing peak in 2006 is a staggering $9 trillion. The latest Case-Shiller Home Price Index reported home prices fell in 18 of the 20 metro areas they track. The national average showed a 2.0% decline in the third quarter of 2010. Home value depreciation appears to have accelerated in September. Some areas of the country are experiencing a very sharp drop in value. The Cleveland, Ohio area saw a whopping 3% decline in September alone and the Portland, Oregon metro area has suffered a 3.6% loss in value in the past year. The home price index ends with the glum conclusion, "Prices are falling – and falling just about everywhere." A survey of real estate experts predicts prices nationally to decline 5% to 8% in 2011 as banks place more of their shadow inventory on the market. The continuing decline in home values is pushing more and more Americans further under water every year. In the third quarter of this year, 23.2% of single family American homeowners owed more on their mortgage than the property was worth. This compares with 21.8% of homeowners a year earlier. Real estate experts say a further 5% decline in home value will push an additional 2.4 million homeowners underwater.

Global Debt - Debt levels throughout much of the developed world are stunning. From small-town municipalities filing for bankruptcy to deeply indebted central governments, economists see warning signals everywhere. The year 2011 may be the year of reckoning for many state and local budgets. With tax revenues remaining anemic, high unemployment, and the end of federal stimulus dollars, already strained states and localities will be forced to deeply slash budgets, increase fees and taxes where possible, and probably layoff many workers. The U.S. debt and deficit continue to rise as Washington politicians search for a painless cure to our fiscal woes. Protests and even riots dot the European landscape as austerity programs cut deeper and deeper into entitlement programs. Currently, the euro zone is the epicenter of the debt problem. Investors have already backed away from some of these heavily indebted nations, forcing bailouts of Ireland and Greece and possible future bailouts of the debt ridden nations of Portugal and Spain. European banks are widely acknowledged to be undercapitalized

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and it is said global banks have $2.28 trillion in exposure to the four weakest European nations. Banking analysts worry that if we see a default in one of these peripheral countries, we could have a full-fledged banking crisis again across Europe. At the present time, the greatest risk to investors is the staggering level of global debt. The manifestation of such an enormous debt threatens interest rates, currencies, and economies around the globe.

SUMMARY

2011 Forecast

- **U.S. economy gains momentum**
- **Investor bullishness is at levels correlated with modest correction**
- **U.S. stocks attractive over five year timeframe, returns of 7%-9% annually**
- **Non-U.S. stocks attractive as global economy expands**
- **U.S. bonds vulnerable to sharp increase in yields over next 12 to 36 Months**
- **Stocks, commodities, and commercial real estate continue to benefit from reflationary policies of world's central banks**
- **Prefer corporate bonds, especially high yield, over treasury and agency bonds**
- **Rising commodity prices, should they continue, pose threat to economic recovery**
- **Short-term, a modest correction in commodity prices is expected**
- **Over long-term, agricultural, energy, and base metal commodities very attractive**
- **U.S. dollar to erode relative to currencies of emerging economies**
- **U.S. dollar to appreciate relative to euro**
- **Sovereign debt levels may disrupt global economic stability**
- **State and municipal debt will contribute to elevated unemployment rate**
- **Unemployment rate to stay elevated due to a myriad of structural problems**

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