

All Eyes on Europe - Still Expect Growth Here in the U.S.

Third quarter growth rates for the U.S. and most developed economies continued to be below expectations. As measured by Gross Domestic Product (GDP), the U.S. economy expanded 1.8% on an annual basis in the third quarter (below the 2.5% preliminary report and the 2.0% first revision). This result compares to 1.3% and 0.4% annualized rates of growth in the second and first quarter of 2011. While the odds of a European recession may have increased due to the spillover of economic, sovereign-debt, and currency woes, we still expect U.S. growth to remain positive in 2012. Current consensus estimate is for U.S. growth of 2.2% in 2012 versus a 1.8% consensus estimate for 2011. The Euro area of 17 countries is forecast to slow from 1.6% in 2011 to a meager 0.5% growth in 2012, with some countries slipping into recession. Japan, however, is expected to show growth in 2012 after experiencing a decline in 2011 due in large part to the aftereffects of the March 2011 earthquake and tsunami.

The December Unemployment Rate surprisingly continued to improve for a second consecutive month to 8.5% from 8.7% in November, after remaining above 9.0% since April. Not only were worker payroll numbers higher than forecasted, with 200,000 jobs being added in December, but other employment indicators rose, such as hours worked and hourly earnings. The job growth came in the private sector while government payrolls continued to decline. For all of 2011, the Unemployment Rate averaged 8.9%, down from 9.6% and 9.3%, respectively in the previous two years. Nonetheless, "it still marked the worst three-year period from 1939 to 1941" according to Bloomberg News. Another statistic that is showing small improvement is the number of long-term unemployed (defined as jobless for 27 weeks) at 5.6 million; this group accounted for 42.5% of the total unemployed, compared to 44.3% in December 2010.

Another bright spot in the U.S. economy is housing starts which increased to a 19-month high – led by a surge in multifamily units (apartments and townhouses). Starts increased 9.3% to a 685,000 annual rate – the most since April 2010. Building permits, which serves as a proxy for future construction, also rose to a 681,000 annual pace in November, the highest level since March 2010. While single family home construction is seeing some improvement, a glut of cheaply priced foreclosed homes remain vacant. At the same time, multifamily construction is experiencing a mini boom as foreclosures force more Americans to become renters.

The Fed Is Keeping Quiet

The Federal Reserve ended its Treasury-purchase program, or Quantitative Easing 2 (QE2), in June and indicated that it was considering no further immediate action to stimulate the economy. In late September, however, the Federal Reserve announced "Operation Twist" which would involve selling \$400 billion in short-term Treasuries in exchange for longer-term bonds starting in October and ending in June 2012. The goal is to push down longer-term interest rates, such as the rate on mortgage interest. At the same time, the twist should raise short-term rates, but with these rates already so low, and while the Fed maintains an accommodative policy, any impact is expected to be minimal. Also, the Federal Reserve Open Market Committee has provided more specific forward guidance

than typical, and with marginal growth, low rates of resource utilization and expectations for subdued inflation over the medium run, the Committee now expects the target for the federal funds rate to be held at its current low levels through at least mid-2013. Also at its scheduled January 25th meeting, the Fed is expected to announce a communications policy that sheds light more immediately on the driving factors steering monetary policy.

Market Performance through the Fourth Quarter

Following a brutal third quarter for global equity markets, the fourth quarter saw a dramatic turnaround with most indices recording double-digit gains in October. Despite the positive start to the quarter, index results were mixed in the last two months resulting in a fairly strong fourth quarter but mixed results for the year. Concerns over sovereign debt worries in Europe that weighed down the economy also depressed equity markets through much of the last half of the year.

While stock returns were mostly negative or low for 2011, fixed income was the place to be. Due particularly to European sovereign credit concerns, demand for U.S. debt securities, especially Treasuries, was strong – helping to raise bond prices.

Stock Market Performance - Fourth Quarter 2011 (Total Returns)

	October	November	December	4Q11	YTD
Standard & Poor's 500 Index	10.93%	-0.22%	1.02%	11.82%	2.11%
Standard & Poor's 500 "Value" Index	11.31%	-0.31%	1.82%	12.99%	-0.48%
Standard & Poor's 500 "Growth" Index	10.59%	-0.13%	0.35%	10.83%	4.69%
Standard & Poor's 400 Midcap Index	13.75%	-0.30%	-0.37%	12.98%	+1.73%
Russell 2000 Index	15.13%	-0.36%	0.66%	15.48%	-4.17%
MSCI US REIT Index	14.41%	-3.74%	4.67%	15.28%	8.70%
Dow Jones Industrial Average	9.72%	1.18%	1.58%	12.77%	8.38%
NASDAQ Composite Index	11.20%	-2.18%	-0.51%	8.21%	-0.79%
MSCI EAFE Index	9.63%	-4.79%	-0.93%	3.40%	-11.67%
MSCI Emerging Markets Index	13.19%	-6.61%	-1.20%	4.44%	-18.37%

Source: Bloomberg

Indices are unmanaged, do not incur fees or expenses and cannot be invested into directly.

Bond Market Performance - Fourth Quarter 2011 (Total Returns)

	October	November	December	4Q11	YTD
Barclays Capital U.S. Aggregate Index	0.11%	-0.09%	1.10%	1.12%	7.84%
Barclays Capital Intermediate Credit Index	1.20%	-1.32%	1.27%	1.13%	5.37%
Barclays Capital Intermediate Treasury Index	-0.23%	0.37%	0.57%	0.72%	6.57%
Barclays Capital U.S. TIPS Index	1.86%	0.77%	0.04%	2.69%	13.56%
Barclays Capital U.S. High Yield Index	5.99%	-2.16%	2.66%	6.46%	4.98%
Barclays Municipal Bond Index	-0.37%	0.59%	1.90%	2.12%	10.70%
Citigroup 3-month Treasury Index	0.00%	0.00%	0.00%	0.01%	0.08%

Sources: Bloomberg, Barclay's Capital, Interactive Data

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Portfolio Positioning - Positive on Stocks

Our basic message has remained consistent over the last several quarters. Near-term risks to economic growth in the U.S. have decreased, and we believe the underlying fundamentals and reasonable valuations support stocks. In this low interest rate environment, the long-term risk/reward opportunity also continues to favor stocks, and we note that overall dividend yields are higher than the yield on the benchmark 10-year U.S. Treasury Notes. At year end, the dividend yield on the S&P 500 was 2.22%, compared with a 10-year Treasury yield at 1.88%.

For fixed income investments, we expect yields to remain near current levels during the first part of 2012 as the Federal Reserve Board's Open Market Committee is not expected to raise key interest rates. For clients with an allocation to bonds, we continue to see value in callable U.S. Agency bonds and higher quality corporate and municipal issuers.

As always, we thank you for your support and welcome your comments.

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