Lassus Wherley ...a view from the top

Building Better Futures

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Risk On...Risk Off...Risk On…

Manic Markets…..

We have had some very interesting discussions over the last few months. There is so much excitement and many interesting happenings when it comes to the current financial markets. We had a debate recently about how to describe these markets. Manic is the only term that seems appropriate in defining the extreme ups and downs we have experienced. We go from super downs because of the lack of action by European leaders to euphoria over some positive event like the recent unemployment numbers.

The bottom line is no individual event would ordinarily warrant the incredible up and down swings that we have experienced if we weren't still in that risk on—risk off perspective. In our October VFT we discussed risk on—risk off which means that the market is being dominated by macroeconomic news (big picture) rather than by microeconomic news (company fundamentals). This macroeconomic focus continues and we see no sign that this will change any time soon. Our 2012 outlook is that the US will continue to move very slowly along the path to recovery and returns will remain largely dependent on what happens in Europe.

The bad news is that we expect continued volatility……….the good news is that we expect positive returns.

The Roller Coaster Ride Will Continue

After a very volatile year, US stocks look to end the year almost flat. After a succession of summits in Europe which were each met by high expectations and disappointing results, European leaders at last look like they might be close to "getting it." Stocks performed better going into year-end on hopes that markets will avoid the severe financial problems that had been feared……….and on improving economic data in the US.

News from Europe has been improving a bit recently as short-term debt has been successfully sold in Spain and Italy. The ECB (European Central Bank) met in early December and decided to take measures to support the banking system. These measures included cutting their base lending rate by .25% and announcing a number of liquidity measures for the banking sector.

Following the most recent European Union summit, a rough outline of a plan emerged, but we still aren't sure if bond investors will give European politicians time to work through the remaining challenges or if they will continue to sell the sovereign debt of the financially weaker countries. Last week, the ECB began lending to banks at the very low rate of 1%. (This rate will be in effect for three years.) As a result, Spain was able to sell Treasury bills in recent auctions at much lower rates than had been expected. The ECB had made it clear for some time that it is not within

their charter to buy debt of the weak countries like Spain and Italy.

European banks, however, are able to borrow and have taken out €500 billion in loans in the past week. These loans being made to the banks must be backed by collateral. The euro-zone banks have been using their own sovereign debt as collateral. This new source of demand has caused the prices of the sovereign debt and that of the other European peripheral countries to firm over the past two weeks.

Investors applauded this move by the ECB in the week heading into Christmas as rates on European sovereign debt declined across the board. With interest rates down significantly, Spain, in particular, looks to be able to roll over their debt at rates which are lower than those at which their debt was trading just a few weeks ago. Investors remain more skeptical about Italian debt because of the size of their debt burden (€1.9 trillion) and because of the amount which will need to be rolled over next year (€350 billion).

This lending by the ECB is a step in the right direction and has alleviated some of the pressure which European banks have been feeling from the lack of short-term funding. (US money market funds have dramatically curtailed their purchases of the short-term debt of euro-zone banks.) Unfortunately, this supply of collateral is not unlimited and is already starting to run low. Liquidity problems could emerge for some euro-zone banks once they are unable to supply the ECB with sovereign debt as collateral.

While European politicians have been discussing plans for further fiscal integration and inching toward common budget rules, two main issues remain to be solved. These are the basic insolvency of Greece and the fact that the euro-zone has the power to run its monetary policy as an integrated union but has no power to tax and spend in an integrated manner. It remains to be seen if the European Union can survive as a currency union.

What's Next for the Global Economy?

These issues will continue to dominate the headlines as we go through 2012. At this point, we believe that the European leaders can still act to prevent financial collapse. The seriousness of the situation has at last become clear to the European leaders. It appears more likely that they will take deliberate steps towards greater fiscal integration than to continue on the path of inaction that they have been on for most of the past two years.

Back in the US, we have seen several encouraging economic reports in recent months. The weekly New Jobless Claims numbers have been trending down, and the unemployment rate dipped down to 8.6% in November. The four-week average of New Jobless Claims has been down for six of the last seven weeks. Layoffs are declining…….and this is good news for consumers and for the economy as a whole, given that consumer spending makes up about 70% of GDP (Gross Domestic Product).

Consumer Sentiment and Consumer Confidence both continue to improve as unemployment trends down. The Reuter's/ University of Michigan's Consumer Sentiment index for mid-December came in at 69.9, up from 64.1 in November. Most of the gain is centered on consumers' expectation that improvement in the jobs market, as well as the stock market, will continue. The Conference Board Consumer Confidence report rose 9.3 points in December to 64.5. Consensus heading into the report was 59. Anyone who went to a mall in December could confirm that consumers were out spending. Whether they were spending savings or taking on new

credit card debt will be seen in the upcoming months.

Last week we also had a good report on the index of Leading Economic Indicators (LEI). The LEI was up sharply with a 0.5% increase in November with a boost from the rate spread which reflects the Federal Reserve's zero interest rate policy and building permits. This report indicates that the risk of an economic downturn in the US is lessening.

When we look at the global economy, we expect slow but positive growth in 2012. The US economy is expected to grow by about 2.5% in 2012. Europe is expected to be in a mild recession in the first half of the year as European banks cut back on lending. China and other emerging markets are in the process of easing monetary policy, and this should boost growth going into and through the next year. China is expected to successfully execute a reasonably soft landing with growth of around 8%. While Europe may be a drag on global economic growth, the US and China (and other emerging markets) are likely to be supportive of growth next year.

Forecasts for growth in the US depend upon Congress passing measures to provide fiscal support to the economy. We hope that Congress will get it together and make the recently approved 2-month extension of the payroll tax cut effective for at least the full year so that consumers will continue to get this boost.

Looking Forward to 2012

Our market outlook calls for a year of positive but somewhat muted returns. Much depends on policymakers both in Europe and in the US taking actions that are difficult but necessary. We would call ourselves optimistic realists in this regard. European policymakers need to come together to embrace greater fiscal integration.

We believe that it is important for investors to maintain reasonable expectations given the challenges that abound.

The Federal Reserve has led other central banks in conducting a very easy monetary policy since the financial crisis. They have also made clear that rates will stay close to zero until at least mid-2013. Very low interest rates should be supportive of stock prices going forward, but stocks are only really cheap if economic growth surprises by going up faster than we expect over the next couple of years.

We expect a continuation of the tug-of-war between attention-grabbing headlines out of Europe and the mainly good news on corporate earnings. Stocks could remain in a trading range for some time as all of these issues are worked out. The factors that could keep stocks at the low end of the range are weaker-than-expected growth, a decline in profit margins, and continued wariness on the part of investors due to concerns about unresolved budget and fiscal issues in the US and the prospect for some kind of financial crisis in Europe.

On the other hand, stocks are reasonably valued if Europe manages to muddle through, as we expect. It won't, however, be enough for stocks to be cheap if Europe's leaders do not continue to make progress in dealing with their sovereign debt crisis. So while we expect that Europe will muddle through, we still anticipate dealing with several more bouts of volatility before we can declare an "All Clear."

It is for this reason that we continue to maintain a higher-than-normal target weighting in Hedge Strategy funds, to keep cash levels higher than normal and to rebalance slowly into equities.

You have certainly read that there have been many strategies that did not work this year. Many so-called experts had a tough year. What did work was diversification. While we

cannot predict the future, we will go out on a limb and predict that this will still be the case in 2012 and beyond.

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Here are some questions from clients. Let us know if you have any questions you would like to share with others.

Question: *What is the VIX and why does it matter?* **Answer:** We have been receiving quite a few questions about the VIX, given the volatility we have been having in the markets this year.

The VIX is the short name for the CBOE Volatility Index. This index was first introduced by the Chicago Board Options Exchange (CBOE) in 1993. The VIX quickly became the benchmark for stock market volatility or risk. It is very widely followed by investors. The VIX has earned the nickname, the "investor fear gauge", because the volatility which it signals often signifies turmoil in the financial markets.

What does the VIX measure? The VIX measures market expectations of near-term volatility. The VIX estimates expected or implied volatility by averaging the weighted prices of SPX puts (bearish options) and calls (bullish options) over a wide range of strike prices.

The VIX is based on real-time option prices and as such, reflects investors' current expectations of future stock market volatility. Option prices tend to rise in periods of stock market stress, which are often accompanied by sharp market declines. The greater the fear, the higher the VIX will go as investors bid up prices of puts as a hedge against future stock market declines. When investors feel more positive about stocks, the price level of options, including the VIX, will decline as there is less fear and thus, less need for investors to buy puts to protect portfolios. Thus, the price of the VIX is high when investors are fearful and low when investors are complacent.

To relate this to the real world, the VIX is definitely one of the indicators that we watch daily. On Thursday, December 29, 2011, the VIX closed at 22.65. The VIX had been as low as 14.27 back on April 28, 2011, as the market approached its high. The highest level that the VIX has been this year is 48.00, reached on August 8, 2011, as investors' fears regarding the European debt crisis were joined with the news of the downgrade of US debt. In spite of the high level of market volatility we are experiencing this year, the level of the VIX remains well below the 80.86 high notched in early November, 2008.

The VIX can be used as a contrary indicator of investor sentiment, along with others such as the sentiment surveys, in attempting to gauge market tops and bottoms. When the VIX is very high, signaling very high levels of fear and investor loathing of stocks, it is often an indicator that the market is near a bottom on a medium-term basis. Conversely, when the VIX is trading below 20, it is often signaling that a medium-term top is near.

Question: *I noticed a shift in the type of money market my cash funds are held in. What is the thinking behind that change.* **Answer:** As mentioned earlier, we have been actively trying to reduce risk levels in portfolios this year given the events in Europe. While we are not overly concerned with the minimal exposure that some money market funds have to short-term foreign debt instruments, in some cases we have changed the default option for the cash sweep vehicle used in accounts. Part of our ongoing process is reviewing accounts for

services provided and expenses. We make changes to update accounts where we believe clients are better served.

Question: *When I watch business news shows in the morning before the market opens, I often hear about the fair value of indexes like the Dow Jones Industrial Average, the S&P 500 and the Nasdaq 100. What is fair value and why does it matter?* **Answer:** The term "fair value" describes the relationship between a futures contract, such as the S&P 500 futures contract, and the underlying commodity that the contract's value is derived from. In the case of the S&P 500 futures contract, the underlying value is the value of the large cap stocks such as Apple, Exxon Mobil, IBM, Microsoft, Chevron and Johnson & Johnson et al which dominate this index.

Basically, fair value is the value of the Index, plus the interest you pay a broker to buy all of the stocks in the Index, minus all of the dividend checks you get from the stocks.

Every morning, before the US stock exchanges begin trading, TV and business news websites give the quotes for the S&P 500, Dow and Nasdaq 100 futures contract. The quoted price movements of the futures contracts in early trading are used by traders as a gauge for how the exchanges may open and trade throughout the day. Index futures are closely tied to the actual indexes.

A futures contract represents a legally binding agreement between two parties to pay or receive the difference between the predicted underlying price set when entering into the contract and the actual price of the underlying commodity when the contract expires. An agreement to buy or sell the S&P 500 futures amounts to a bet on how the index will behave over a set period of time. Like any other financial security, the value of the this agreement, or futures contract, changes moment to moment based on what traders believe it is worth.

Because the index and the futures contract are so closely related both in price movement and value change, index futures are used to gauge the direction of the market.

When you hear that the S&P 500 fair value is trading at +10, this means that the futures contract needs to be 10 points above the cash index's previous close to be at its fair value. Before the market opens, if futures are trading above fair value, then traders are betting the market index will go higher. The opposite is true if futures are trading below fair value.

Question: *I noticed you purchased an ETF with the symbol VT. Why are you using this fund?* **Answer:** In an ongoing effort to allocate portfolios in the most efficient manner possible, we have added this fund where we believe it will add value.

The Vanguard Total World Stock ETF is a global equity-based index fund that is designed to track the FTSE® All-World Index. The fund provides diversified exposure to the global equity markets by investing in roughly 50 countries, comprised of 2,800 different companies.

Our criteria for adding the fund to specific accounts is fairly straightforward. From a cost effectiveness standpoint, VT allows us to gain exposure to domestic, international and emerging markets in one fund. This provides an opportunity to control transaction costs which over time can drag on the performance of a portfolio. In accounts with relatively small-market values, this is a real benefit. We typically prefer to use individual funds for each asset class. However, when an account value is very small, the costs associated with doing this

outweigh the benefits. VT is used to supplement overall equity exposures in a cost conscious way.

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Someone recently ask me if I wrote this newsletter. The answer is that it is a team effort with Anne Kehl doing much of the technical analysis and our other team members providing articles on specific topics. Our team makes my job as editor much easier.

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Have a safe, warm and very Happy New Year and here's looking for a great 2012!

Diahann

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