2010 REVIEW OF MARKETS: STORES OF VALUE

"These are extraordinary times. A massive de-leveraging has barely begun across the industrialized world…in a world awash with debt, repairing the balance sheets of banks, households, and countries will take years."

Bank of Canada Governor Mark Carney in a speech to the Economics Club of Toronto
December 14, 2010

"It would be desirable for the global community to devise an international monetary system that more consistently aligns the interests of individual countries with the interests of the global economy as a whole."

U.S. Federal Reserve Chairman Ben Bernanke in a speech to the European Central Banking Conference in Frankfurt Germany, November 19, 2010

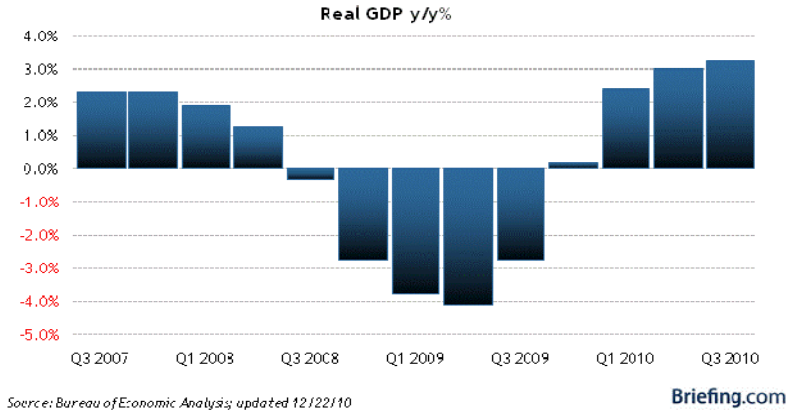
Investors in stocks enjoyed another strong, yet volatile, year, as earnings and profits strengthened globally, despite the massive increase in public sector borrowing in much of the developed world. Almost all returns in equities were generated in the last quarter of the year, with December alone up a whopping 6.68%. Bond investors had a less ebullient, albeit positive year, as central banks generally continued easy money policies (ultra-low short term rates) to counteract large output gaps, continued high unemployment, and weak consumer demand. Precious metals and commodities resumed a strong uptrend, driven in large measure by the constant flow of yet more fiat currency (money/liquidity creation) bidding up the prices of finite "hard" assets. The table below summarizes some 2010 asset returns:

	2010	Last 3 Years	Last 5 Years	Last 10 Years
S&P 500 Total Return	15.07%	-8.32%	11.99%	15.05%
Value Line Composite	20.47%	-15.46%	-9.77%	-5.40%
MSCI EAFE	8.21%	-18.38%	15.58%	47.11%
MSCI Emerging Markets	19.20%	-0.09%	85.15%	349.98%
Citigroup 5 Year T-Note	6.93%	20.34%	35.99%	72.42%
Barclays Five Year Muni	2.43%	16.38%	26.45%	58.40%
DJ UBS Commodity Index	16.83%	-10.60%	6.06%	76.45%
Gold (London PM Fix)	29.24%	69.54%	165.19%	412.11%
CPI	1.33%	4.17%	11.18%	25.75%

Note: All returns are cumulative, not annualized

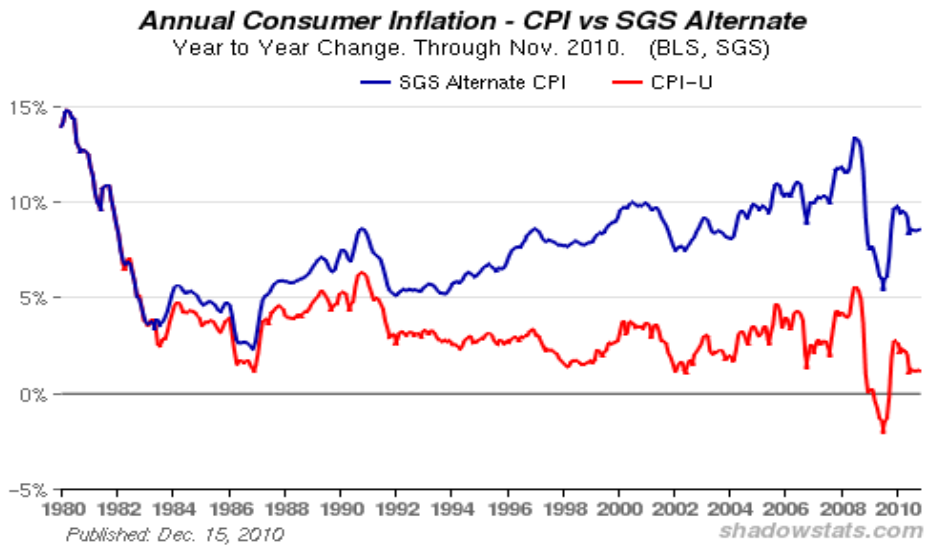
Macroeconomic Environment

2010 saw a recovery in economic activity in the US and many countries around the world, with the US "officially" declared out of recession. Annualized GDP growth trended towards 3.0% as the year closed:

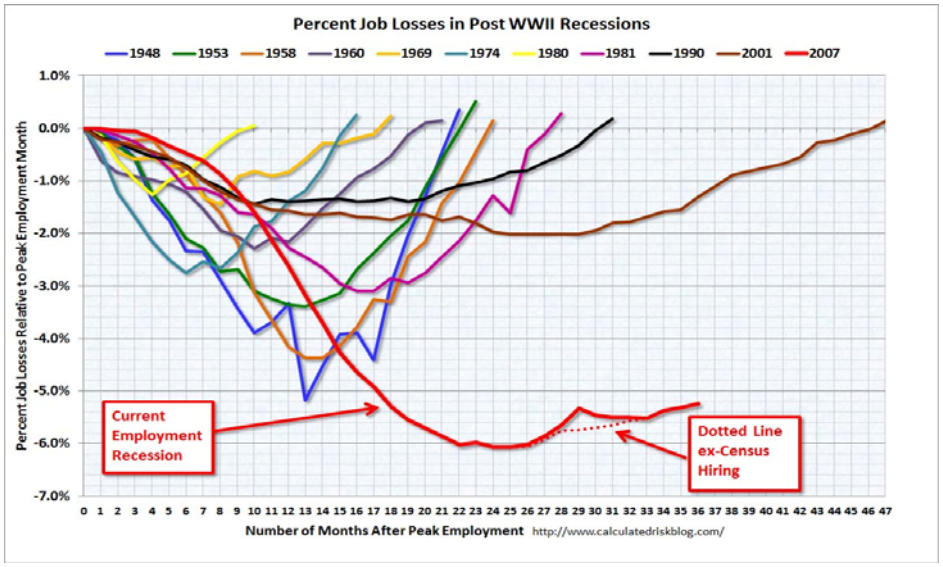


Domestically, much of the growth came from replacing depleted inventories with new product, not consumption. The big question going forward is how the economy will do when the real belt-tightening gets underway this year. The new Congress is not going to support the level of expenditures that occurred over the last two years, and now state and local governments are entering a period of "hard math", where zero-based budgeting rules, and essential services will be cut. Estimates vary widely on job losses, but the trend is straightforward: less contribution to GDP from the public sector, and therefore less "stimulus" for the economy.

Inflation statistics have become increasingly disconnected from reality. The "official" CPI yearly change is running at 1.1%, and "core" CPI is at .80% (excluding food and energy). A visit to your neighborhood grocery store or gas station would not square with those low figures. An "alternative" CPI has been developed and tracked by John Williams, which removes the "tinkering" the government has done since 1980 to keep increases to a minimum:

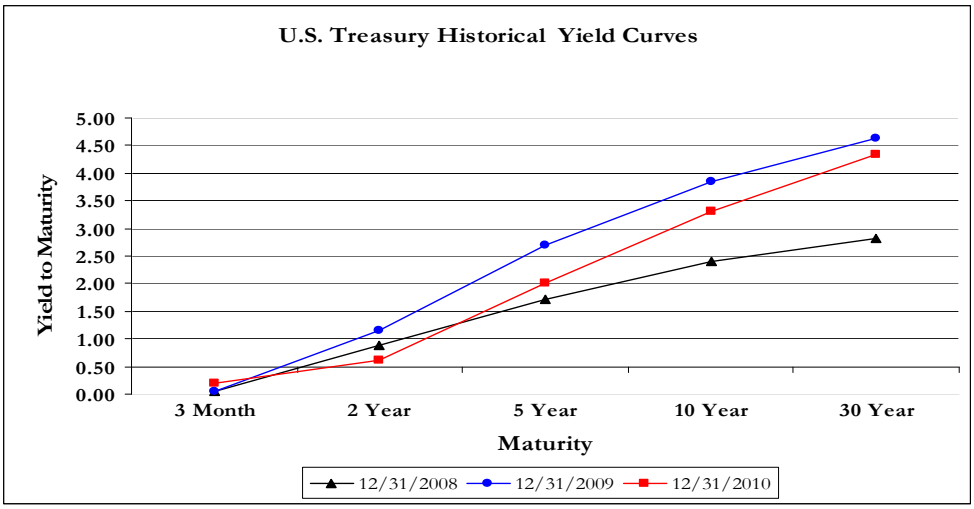


Loss of public sector jobs, combined with diminished fiscal stimulus and reduced income among consumers, is likely to keep aggregate demand in the US tepid for a while longer. Simply put, it is hard to make the case for a vigorous expansion until more jobs are created, and the U.S. has quite a lot of catching up to do to match prior recoveries. Is it different this time?



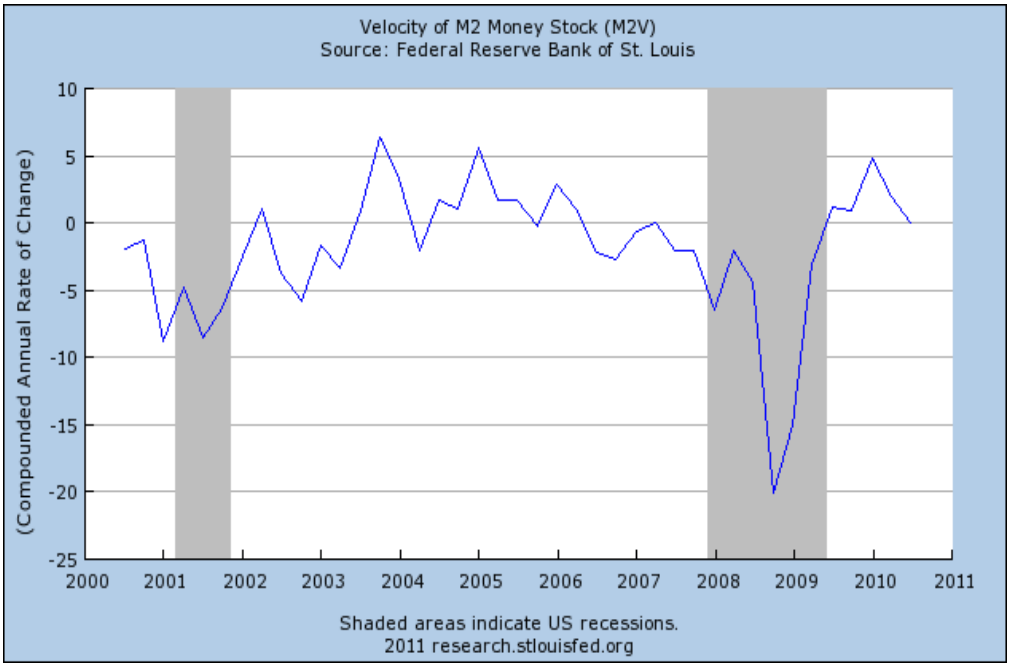
Bonds

U.S. bonds gyrated throughout 2011, but wound up the year with lower yields, as short term interest rates remained at abnormally low levels:



Monetary policy is highly accommodative, with short term rates at near zero and the Fed supporting the economy by a resumption of "Quantitative Easing" (Round Two), by which they create dollars to purchase US Treasury debt. The Eurozone is pursuing much the same course, and investors are debating whether or not this policy will "work".

The evidence for now is that asset prices, especially stocks, are rising as this new money enters the system. In the real economy though, things look different. The chart below shows how much money is "spent" in exchange for goods or services, thus contributing to GDP (on a rate of change basis). It is clear from the "trough" of 2008 how powerfully effective Fed actions have been, but it is also clear that peak growth rates are decelerating. When juxtaposed against the jobs chart above, one could conclude that something is missing in the recovery story:



On the bright side, the U.S. is doing much better than Japan and Europe in its growth revival. Monetary policy is ultra-low in both areas, with sluggish growth overall and national balance sheets that, for the most part, range from treacherous to unworkable. While often pilloried long term, the US Dollar is still the world's reserve currency, and it will serve as a "safe haven" this year when bouts of instability crop up. The US bond market should respond favorably in these periods, and it still remains, in our view, the natural beneficiary of all the deflationary tendencies in much of the developed world.

U.S. corporate and high yield bonds (credit or "spread" product) have done well this past year, and should continue to offer reasonable excess yields, barring a sudden slowdown in the U.S. or unexpected change in U.S. Fed policy. The "Option Adjusted Spread", or OAS, illustrated below shows a return to a more normal relationship after the meltdown of 2007-08:

Source: Bank of America Global Index System

As 2010 closed, yields in the U.S. municipal bond market rose sharply, with pundits voicing concern about potential defaults and looming bankruptcies:

Source: Bank of America Global Index System

The extraordinarily large and diverse universe of municipal issuers (several hundred thousand) means that some entity somewhere will undoubtedly fulfill those predictions. The broad orientation, though, should be that debt service costs are manageable for almost all cities, states, and counties, even with markedly lower tax receipts. However, the bond market has been known to "riot" from time to time, so when the *perception* arises that an issuer is in trouble, they may find it hard to sell new debt, and thus pay off maturing issues. We fully expect some big, bad headlines this year around municipal bond stresses, but are comfortable that most investment grade general obligation issuers have been properly assessed by the ratings agencies and have the means to move through any turbulence, especially the "investment grade" variety. Our preferred

category within municipals remains 100% US Treasury backed "pre-refunded" or "escrowed to maturity" issues, which tend to sell off with the rest of the muni market. Investors should view any sell offs as a gift.

As a longer term theme, many strategists recommend reducing US Dollar exposure by buying local currency bonds from emerging markets (several new ETF's have been launched around this strategy). We continue to view the currency intersection as being of primary importance when considering bond exposure, and we think it is critical to evaluate local monetary policy as a tool for analysis. Both China, India, and Brazil have been raising short term rates, albeit on different timelines and business cycles, and this may influence the flow of capital, and currency and bond values in different ways. Investors should not automatically assume that investments in these bond markets are stable, and will always rise in value.

In the developed world, sovereign debt issuance is set to accelerate. Countries of the Eurozone face $3 trillion of refinancing this year, and the US about $4 trillion, according to the Institute of International Finance. The cost of refinancing is rising, as interest rates and credit spreads price in the compensation that investors require for bearing increasingly uncertain risks. Chief among these is the ability of central banks to continue to buy these bonds with newly created money, and the impact of so doing. In Europe, a widely tracked index of CDS now tells us bonds of Eastern and Central Europe are more desirable than the Western European nations. Net debt as a percentage of GDP will continue to rise in the absence of growth, and investors could reasonably conclude that yields may rise, especially if the "bond vigilantes" grow impatient with the pace of structural reforms needed to restart private demand and growth. "Rollover risk" is going to be a hot topic in 2011.

Stocks

Equity prices rose in 2010, supported by a continuing recovery in earnings from the trough of 2008. S&P 500 earnings rose 47% to $83.63 in 2010, and are expected to rise to the low to mid $90's per share in 2011. U.S. sector returns were all positive last year:

Basic Materials	19.9%
Consumer Discretionary	25.7%
Industrials	23.9%
Energy	17.9%
S&P 500	***15.07%***
Telecommunications	12.3%
Financials	10.8%
Consumer Staples	10.7%
Technology	9.1%
Utilities	0.9%
Health Care	0.7%

Source: Standard & Poors

Value and growth styles ran neck and neck in 2010, while smaller and mid-cap companies were favored over large, high quality players:

Russell 3000 Growth Index	17.64%
Russell 3000 Value Index	16.23%
S&P Midcap 600 Index	26.64%
S&P 500 Index	15.07%
Russell 2000 Small Cap Index	26.85%

Meanwhile, foreign market returns varied widely, as correlations diverged and global equities provided more of a diversification benefit:

Australia All Ordinaries Index	-1.02%
Japan NIKKEI	-2.77%
MSCI China Index	4.83%
SENSEX Bombay (India)	17.43%
RTS Index (Russia)	22.54%
Germany DAX Index	16.06%
Spain Madrid Equity Index	-18.91%
BOVESPA (Brazil)	1.05%
Canada TSE Index	14.45%

Equity investors have enjoyed two solid years of gains, and most observers, including the Barron's Roundtable and Blue Chip Economic Forecasts, are looking for continued economic growth and positive equity returns this year. The positive bias is augmented by the strong probability of rising stock markets during the third year of a Presidential Cycle (up an average of 11% over 78% of the time, according to S&P).

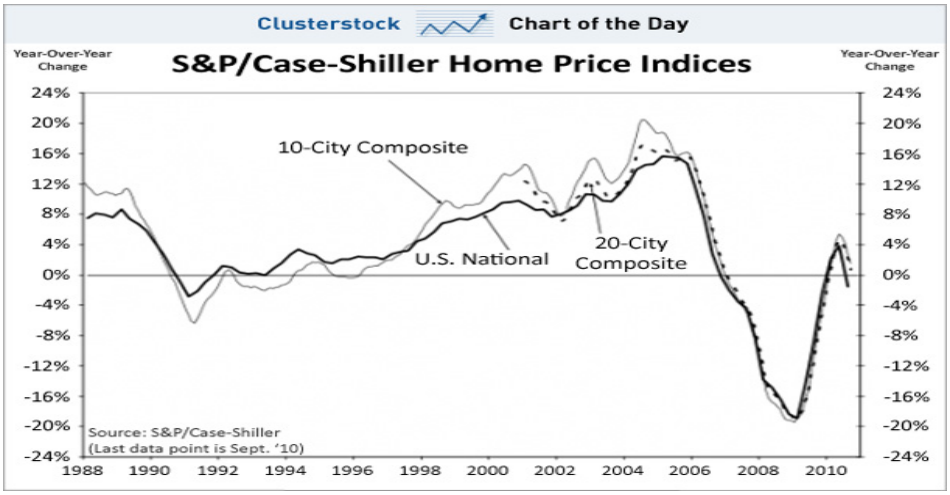
While respecting the "odds", investors must grapple with a third new "mandate" from the Fed (full employment and price stability being the stated goals of monetary policy). Bernanke has stated explicitly that another goal of QEII is to raise stock prices. In Japan, their central bank in the past has bought equities and REIT's to help support markets, and one has to wonder whether or not the Fed is or will be doing the same thing here. This type of intervention conflicts with fundamental valuation and price-setting mechanisms, and should be discouraging to long term investors.

We also note a troubling trend in trading. According to Raymond James Financial, 33.8% of all stock trades occurred off the major exchanges in Q4 of 2010, with prices unreported and activity cloaked inside so-called "dark pools", which are privately operated electronic exchanges that allow large institutions to cross blocks of stock among themselves. Blackrock, among the world's largest money managers, is implementing an internal "crossing" system, where it will trade with itself and bypass all exchanges, public or private. This emerging global trend is a harmful development for both price discovery and liquidity, and will surely increase volatility and decrease confidence in Western style capital markets. If there was ever a case for regulatory reform and oversight, this is it. In conjunction with the continued lack of uniformity in clearing and reporting in the massive global derivatives markets, investors should remember that systemic risk is ever present, and the need for "tail-risk" management has not abated.

Housing Setback

The U.S. has many unprecedented issues to deal with, but foremost among them is the continued inability of the housing market to regain traction. While the Obama Administration is set to release shortly its' proposals for Fannie Mae and Freddie Mac going forward, the Massachusetts Supreme Court ruling of January 7 should be interpreted as the new "shot heard round the world". The ruling upheld a lower court's decision to void foreclosure sales of two homes because owners of the two loans (Wells Fargo and US Bancorp) could not prove that the mortgages had been assigned to them. These loans wound up in mortgage-backed securities sold to investors.

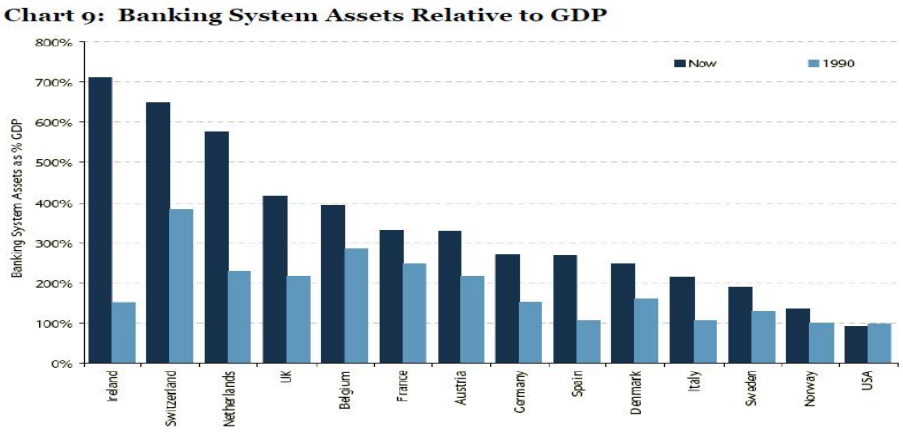
Never was the phrase "tip of the iceberg" more apropos, and it is likely that a few more years were just added to the housing market recovery, as legal precedent now exists for challenging just about every underwater mortgage in America (one in four). When coupled with the much more difficult credit application and qualifying process, along with higher mortgage interest rates, the housing market could not have been dealt a poorer hand. Housing prices are reflecting a renewed weakening pattern, and uber-expert Robert Shiller sees another 10% decline in prices as well within the bounds of normalcy:



Euro Debt Crisis III?

It goes without saying that the problems of Europe continue, flaring up with Greece last spring and Ireland as the year closed. It is likely to bubble up again in the persons of Portugal and Spain early this year, as those countries need to raise gobs of money through the sale of sovereign bonds to replace their maturing issues. Will the bond market go on strike? Both countries have said the current rate of interest (north of 7%) is "punitive", but claim at the same time that they will not need a "bailout". (New-found friends from China have been showing up in Lisbon and Madrid to pledge their "support".)

Apart from ill-advised blanket state guarantees on debt, the real problem is the miserable condition of the indigenous banks in Euroland, which wildly over-lent and now cannot find enough capital to replace those assets/loan collateral that have been vaporized. The relative size of banking assets relative to GDP below tells the story:



Source: Barclays Capital

The USA looks positively pristine compared to the Eurozone. Raising capital will be the name of the game, and Germany will have a lot to say about the "rules of engagement". Until there is some clarity in the path forward, the Euro will likely bear the brunt of investor skepticism. However, there is a different flavor to the debate, as the EU introduced a proposal recently for "bail-ins", i.e. making bondholders take losses—but only after 2013. It will be a bumpy ride between now and then, but Germany has committed to supporting the Euro under all scenarios.

Germany has also amended its Constitution to require a completely balanced federal budget by the year 2020, thus making it the hardliner of Europe on fiscal policy. But the European Central Bank is emulating the US Federal Reserve in its Quantitative Easing monetary policy, and these increasingly incompatible goals will mirror the debate in the US and elsewhere: Austerity vs. Stimulus. The intersection between the hard-working German Burghers and their government will

be the most interesting one to watch, especially if more violent forms of protest erupt. (Some readers may recall the Baader-Meinhof "gang" of the 1970's, who, among other despicable acts, kidnapped and murdered Hans Martin-Schlyer, then President of the Confederation of German Industries, in protest against "capitalist pigs" and the continued imprisonment of their Red Army Faction "comrades".) Social unrest is the one outcome that no government desires, and the process of European resolution will accelerate if the temperature rises in Deutschland. (It's OK for the Greeks and French and Spanish to protest, but when the stolid Germans get upset, look out.)

The other wild card is the upcoming Irish election on March 27. Opposition party Fine Gael has run on a platform of restructuring the bailout package "requested" from the EU and IMF. If they win, bond investors will likely lose, and the credit markets will once more enter the twilight zone as risk is re-priced in response to "nano-ticks" of rumor and political jostling. We have said before that the Irish are not going to take their loss of financial sovereignty quietly, and this could be the turning point for the Emerald Isle (joining Iceland in telling investors to stuff it, suffering for a brief period, and now doing quite well indeed thank you.) In short, the drama in Europe will continue, and investors should get used to periods of calm followed by storms.

Redbacks

Quietly, and barely noticed in the mainstream U.S. press, China has been loosening the rules on the use of its currency, the yuan, or renminbi, by residents and foreigners alike to encourage its adoption. Last June, China expanded its yuan trade settlement scheme to every country in the world, allowing imports and exports to be invoiced and settled in yuan (thus neatly side-stepping the extra transaction costs and currency exchange risk of the "greenback" U.S. dollar). In July, Hong Kong yuan depositors were allowed to trade the currency for the first time. In August, foreign companies were allowed to sell yuan denominated bonds--called "dim sum" bonds for now--in Hong Kong for the first time (McDonald's and Caterpillar quickly tapped the market). This month, Chinese companies will be allowed to move yuan offshore for investment purposes and trading for the first time. And, in London, a leading global macro hedge fund has announced plans to raise $500 million through a yuan based share class.

This litany of initiatives is part of a long term plan by China to make the yuan a fully convertible and freely traded global currency. Despite calls from both the U.S. and Europe to let the yuan rise in value, China is fearful of currency volatility and the probable harmful impact a rise would have on its export industries, and continues to maintain a trading "band". This nascent market is going to gather much more momentum in 2011, and, especially in Asia, the "redback" yuan will become more frequently used for trade. It will be interesting to see how Chinese central planners navigate the waters if market forces create waves. Keep the buckets handy?

Outlook and Strategy

We've been talking about the coming age of austerity for some time, and the concept has now registered firmly with the general public. Merriam-Webster Inc., America's leading language reference publisher, announced that **austerity**, defined as "enforced or extreme economy", had topped its list of the Top Ten Words of the Year for 2010. According to the press release: "Lookups for austerity peaked dramatically several times throughout the year, as people's attention was drawn to global economic conditions and the debt crises in Europe, but lookups also remained strong throughout the year, reflecting widespread use of the word in many contexts. 'Austerity clearly resonates with many people,' said Peter Sokolowski, Editor at Large at Merriam-Webster, who monitors online dictionary searches. 'We often hear it used in the context of government measures, but we also apply it to our own personal finances and what is sometimes called the new normal.'"

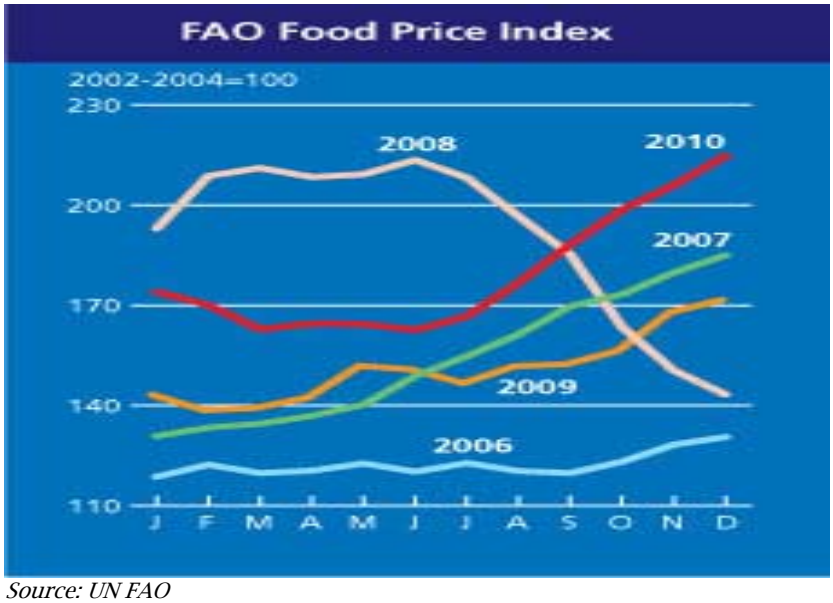
How each country copes with demand and supply side imbalances is going to have a lot to do with their progress in the Age of Austerity. Monetary and fiscal policy aside, we think tax policy is going to play a very large role in solving the problems of too much debt and not enough growth. Little noticed by most market observers, Canada continued its' program of lowering corporate tax rates in 2010, with a 16.5% rate effective in 2011, on the way to 15% in 2012. This will make five cuts in five years. (As recently as 2000, their rate was 42%.) Canada will have the lowest tax regime in the G7, while the US corporate rate remains at 35%. This has very meaningful implications for investors, who eventually go where capital is treated best. It also will help to differentiate policy responses in the slow growth developed world. Our hunch is that GDP growth in Canada will

continue to be among the G7 leaders. With a sound currency and banking system, there is not much to dislike about our Northern Neighbor.

In fact, Bank of Canada Governor Mark Carney is widely regarded as the most skilled central banker of our time, and Canada has emerged relatively unscathed from the debt and currency pressures that are afflicting many other developed countries. Canada's persistent independence and clear-eyed recognition of a long period of debt de-leveraging ahead is in striking contrast to the U.S. Fed, whose Chairman Bernanke has bailed out foreign banks (in clear violation of the Federal Reserve Act of 1913), and who is now calling for a new international monetary system (Bretton Woods III?—see our quotes again that began this review). Major shifts are underway in both the economic and political worlds, and for investors, the journey to a new monetary system will run straight through the U.S. Dollar, Euro, Yen, Yuan, and Gold. In other words, how the world recognizes a store of value and medium of exchange is likely to change—perhaps radically. It is the question of our age.

Emerging markets have become the favored destination for a large swathe of global investors, with a "How to Play Emerging Markets" story recently gracing the cover of *Barron's* magazine. The stampede of foreign capital into these countries has caused local currencies to rise, and authorities have increased transaction taxes and imposed capital controls (most notably Brazil) to dampen enthusiasm. Less perceived, but surely more important, have been the opening salvos in monetary tightening policies, as China, India, and Australia have increased interest rates recently, which could dampen enthusiasm for risk assets like stocks. The hope is that monetary authorities can nip inflation in the bud without damaging growth prospects.

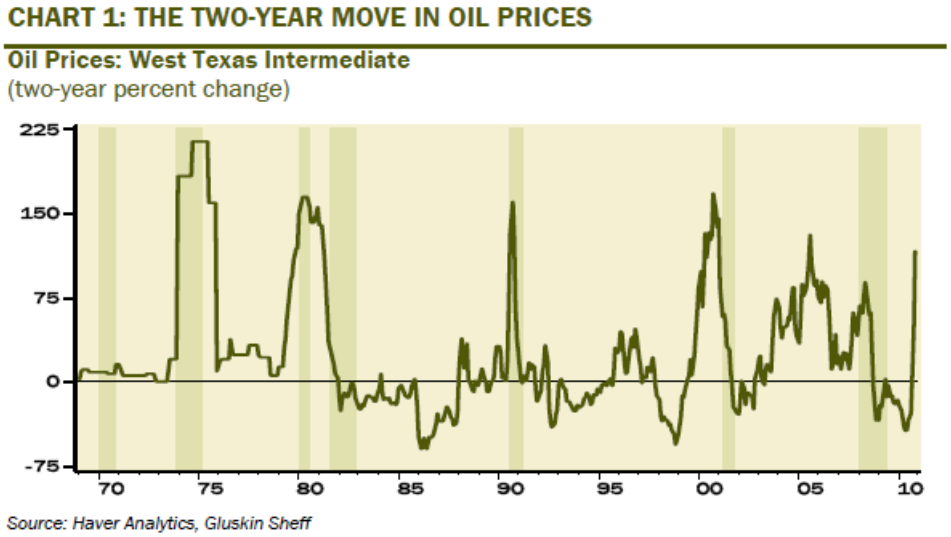
The tightening is coming about in large measure due to an increase in inflation driven by rising food prices. The UN Food & Agriculture Organization (FAO) recently released their broadly based Food Price Index, and it shows the sharp acceleration on the cost of these most basic of all goods, now surpassing the last peak seen in 2008:



Source: UN FAO

Droughts in Russia and the Ukraine, flooding in Australia, and scorching heat in South America this summer (now) all add up to a very real change in the supply dynamics for agriculture. New demand through investment related vehicles (ETF's) and nonsensical programs like the US ethanol mandates (burning corn for fuel?) are distorting natural sources of demand, and it all adds up to a very uncertain pricing environment for food. Combined with an inexorable rise in global population, upward pressure continues unabated. Higher interest rates cannot in and of themselves restrain price increases when the supply/demand equation is skewed so badly, and we are keeping a very close eye on this critical area.

A resumption of global growth has also driven oil prices higher, yet they have badly lagged other industrial metal prices like copper, iron ore and palladium. We remain constructive on oil as Asian consumption rises inexorably, and supplies remain threatened by geopolitical and exploration and production constraints. The graph below also demonstrates a cyclical bent in oil pricing, with sustained positive increases becoming more of a "norm" recently:



Gold and precious metals have had an unbroken decade long winning streak which may be due for a pause. If global confidence increases in government and central bank solutions, gold could suffer near term, but ultimately, mopping all the world's excess dollars is going to produce some serious inflationary turbulence, and that's when gold will shine even brighter. We remain committed to owning precious metals and gold mining shares.

The underlying thesis remains valid for having a global growth orientation, but higher interest rates tend to reduce the value of stock prices (the old "discount rate" and "net present value" functions from Finance 101). The interest rate picture in "growth/developing" economies should be monitored especially closely, while developed markets have had a significant "back-up" in yields already, making them relatively attractive.

Lastly, equities have rebounded and sentiment is notably bullish as the year begins. That's always a good time to reduce exposure and buy protection (volatility has collapsed.) Just as in 2010, we expect trading opportunities to arise, but staying nimble is going to be even more important. The great news for investors is the extraordinarily diverse instruments that are now available to customize and tailor portfolios to match outlooks. The "investment opportunity set" has never been richer, and the only resource in short supply is time to explore the vast panorama of the bold new investment landscape. But our boots are laced and we're well equipped—and the trail awaits!

Robert E. "Emery" Pike, CFA
Managing Principal and Chief Investment Officer
January 14, 2011