STANDARD & POOR'S

# 2011 - Annual Economic and Investment Outlook

*Overall, 2011 should be a good year - but not a great one - for the economy and equity markets, according to Standard & Poor's.*

Although the longest and deepest recession since World War II officially ended some time ago, the digging out continues, and S&P Economics believes the recovery will continue to be slow and uneven in 2011. What follows is a summary of analysts' reports from Standard & Poor's.

## The Economy

The U.S. financial system appears to be stabilizing, thanks in part to massive fiscal stimulus applied during earlier stages of the recession. The Federal Reserve also helped by lowering short-term interest rates to near 0% and by injecting liquidity into the economy at key points. In addition, America's overseas trading partners are well on their way to economic recovery, which should boost U.S. exports, albeit slowly. Given these positives, S&P Economics forecasts modest 2.6% growth in the U.S. economy (as measured by GDP) in 2011.

There are negative factors that continue to weigh on the economy:

- **Consumer spending**, which in the past has led the economy out of recession, remains sluggish. Americans are still reeling from losses sustained in their retirement accounts over the past few years, and the fear of job loss is still a reality. As such, S&P anticipates consumer spending to grow a modest 2.7% in 2011.

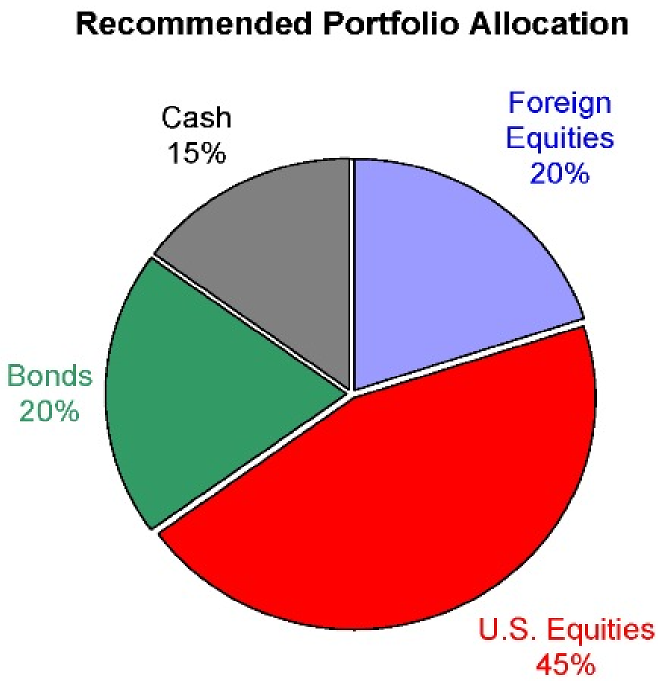
- The **housing market** continues to soften. Last spring's surge in sales and prices was clearly a temporary response to the tax rebate. Once the rebate expired, sales slowed and prices receded. The S&P/Case-Shiller Home Price Index fell 2.0% nationally in the second quarter and housing is expected to remain weak for most of 2011.

- **Employment** remains the biggest concern facing the nation. The unemployment rate bounced back to a seven-month high of 9.8% in November and will clearly break the 1982-1983 record of 20 consecutive months at or above 9% (now 19 months and counting).

## The Investment Markets

Although market volatility may increase in 2011, S&P's Investment Policy Committee (IPC) believes that investors will be rewarded by maintaining a slight overweighting to equities at the expense of bonds.

**U.S. equities:** After rising 12.5% in September, October, and November, the S&P 500's advance continued with the index gaining a healthy 6.5% through December 31. Better than expected U.S. economic data and the extension of the Bush tax cuts helped to bolstered investor confidence. The IPC's 12-month target for the S&P 500 is 1315, which represents a total return of roughly 7% from current levels. In addition, S&P 500 earnings per share (EPS) are estimated to rise 13.2% in 2011, to $94.80, with seven of the ten S&P 500 sectors posting full-year EPS increases.




***Source:*** *Standard & Poor's Investment Policy Committee recommendation for an investor of average risk tolerance and time horizon as of January 1, 2011. This recommendation is subject to change as conditions warrant. Individual circumstances vary and may suggest the need for adjustments. Asset allocation does not assure a profit or protect against a loss in a declining market.*

**International equities:** After posting strong gains in 2009, most global equity markets continued to rise modestly in 2010, with emerging markets leading the advances and Europe trailing.

As we enter 2011, we see a developed foreign equity upside continuing thanks to attractive valuations and solid fundamentals in Northern Europe, Canada, and Australia. Lingering jitters about sovereign debt and potential weakness in the euro - whose volatility detracts from U.S. investors' dollar-denominated developed overseas equity returns - may constrain gains somewhat.

As for emerging markets (EM), we think faster secular growth, reasonable valuations, and attractive dividend yields make continued outperformance likely in 2011. Currently, the greatest threat to EM economic expansion is growing inflation in nations such as China, India, Brazil, and Indonesia - all of which have begun to raise interest rates in an attempt to stifle price pressures. That said, our belief is that EM economies will continue to expand fast enough to power the global economy and fuel mid-teen profit growth.

**Fixed income:** The 2011 investment outlook bodes better for stocks than bonds, according to S&P, which currently advises a 65% weighting to global equities in its recommended asset allocation and only a 20% weighting to fixed income. S&P Chief Economist David Wyss advises investors who want bonds to stay with those with maturities of two to five years. "We still believe that yields will go up in time, so it's better not to lock in with an investment in a longer-term bond at today's low rates."

### Implications for Investors

**Third year a charm?** The year 2011 should offer a trio of three-year milestones:

- In January, President Obama begins his third year in office.
- In March, the S&P 500 starts the third year of this bull market.
- In June, the U.S. economy enters its third year of recovery.

Since 1945, the S&P 500 has risen an average 17% in the third year of a president's term in office, while bull markets and economic expansions have historically lasted an average of more than four years each. While market volatility may increase over the coming year, we believe that equity prices will increase as well.

**Consider the value of dividends.** During the past 10 years, the S&P 500 lost value on a price-only basis, sliding 4.7% from December 31, 2000, through December 31, 2010. Yet if the value of dividend reinvestment is included, the index moves back into the black with a 15.1% cumulative 10-year return. Some data suggests that stocks paying dividends have become an increasingly important source of income for retirees, and when compared to current yields on long-term bonds, equity dividends are likely to rise with inflation over time. Equities also offer attractive long-term capital appreciation potential.

**Evaluate your current winners.** If you are a believer in "reversion to the mean," in which the leaders in one decade become laggards in the next, then you might want to keep a watchful eye on U.S. mid- and small-cap stocks, emerging market equities, and gold. And from a sector standpoint, the same goes for the energy and materials groups, and to a lesser extent, the consumer-oriented areas.

**Don't sit on the sidelines.** Investors who pulled out of their investments during the market decline of 2007-2008, probably lost the opportunity to benefit from subsequent gains in 2009-2010. While volatility appears likely to continue, it doesn't mean you should shy away from investing.

**Understand that diversification can help reduce - but not eliminate - risk.** Mixing asset classes with low correlations (equity-oriented investments with fixed-income instruments) may help cushion declines, but not eliminate them.