MURRAY
INVESTMENT MANAGEMENT

4th Quarter 2010 Update

Economic Review

U.S. economic data was generally positive during the 4th quarter with the overall economy posting moderate growth. Unemployment (currently at 9.4%) remains the primary economic concern, but the employment situation did show some improvement during the year.

The second round of Quantitative Easing ("QE2") by the U.S. Federal Reserve was arguably the biggest economic story in the 4th quarter. The Fed's objective with QE2 is to lower interest rates by purchasing Treasury bonds. The lower rates should stimulate borrowing, increase economic growth and force investors into riskier assets such as equities and corporate bonds.

The Fed's bond purchase program was met with a great deal of resistance, and the results are still under question. Since the program was announced in early August, interest rates have generally moved up instead of down as the program intended.

In addition, after Republican wins in November, Congress and the White House were able to reach an agreement on extending the Bush tax cuts. While only an extension, the compromise does give some short-term clarity to tax policy.

Equity Market Performance

	4Q10	YTD
S&P 500	10.76%	15.06%
MSCI EAFE (International index net return)	6.61%	7.75%

U.S. Equity markets produced strong results for the 4th quarter and for the entire 2010 year. Most of the positive performance occurred in the latter part of the year (late August through December) and was partly attributable to 1) Ben Bernanke speaking out to support additional Quantitative Easing measures and 2) the success that the Republican Party had in the November elections.

The broad International markets also produced solid results although not as robust as in the U.S. The European debt crisis partially contributed to this relative underperformance. Emerging International markets, however, produced particularly strong results.

Overall, performance during the year highlighted the importance of diversification. For example, Small Cap stocks (Index up 26.85%) significantly outperformed Large Cap stocks (Index up 16.10%) while, as noted above, Domestic Stocks (Index up 15.06%) outperformed International Stock (Index up 7.75%) by a wide margin.

Bond Market Performance

	4Q10	YTD
BarCap US Aggregate Bond (Broad Bond Market)	-1.30%	6.54%
BarCap Municipal	-4.17%	2.38%
BarCap US Corporate	-1.61%	9.00%
BarCap US Corporate High Yield	3.22%	15.12%

U.S. Fixed Income markets were generally higher for the year, but many areas of the market fell during the fourth quarter as interest rates moved up. During the quarter, inflation concerns, a more robust economic outlook and a bloated U.S. deficit seemed to outweigh the Fed's attempt to drive down rates with QE2.

The Municipal Bond market was particularly weak during the quarter as the year-end expiration of the Build America Bond program and concerns about the financial health of U.S. municipalities put pressure on yields in this space. In contrast, the Corporate High Yield space produced strong results during the quarter and the year.

Economic Outlook

The U.S. Economy should continue to deliver modest growth with low inflation during 2011. Accommodative Fiscal and Monetary policies should serve as tailwinds for growth during the year, and corporate spending should pick up. Many U.S. companies have been growing and hoarding cash, and with more confidence that the economy is on firmer footing, companies are more likely to spend and invest which should lead to further economic growth. With high unemployment and the economy growing below trend, short-term inflation does not seem to be a major concern.

Two areas that need to be monitored closely include the following:

1. Employment

To a large degree, consumer spending drives the economy, and unemployment is likely to remain high in the short-term. The jobs picture has improved and is expected to continue

Source: bls.gov, Morningstar, online.wsj.com, and CNBC.com
The performance data shown represents past performance, which is not a guarantee of future results.
Return data is as of 12/31/2010. Except as noted, index returns are Total Returns.

improving, but the monthly jobs report should be monitored closely for any change from the overall improving trend.

2. U.S. Debt

Eventually there will be a price to pay for the massive amounts of borrowing that the U.S. Government has done and continues to do. Borrowing and spending will have to slow, and a plan to get out of this cycle should be detailed in the coming year. But with the recovery still somewhat fragile, the implementation of significant budget reductions have been put on hold for now. In addition, state government budgets should be monitored for any potential municipal bond defaults.

Market Outlook

In 2011, it's not unreasonable to expect equity markets to grind higher driven by earnings growth and an improving economy. Investors should not expect double digit returns like domestic markets produced in the last 2 years but should expect more modest returns.

Even after a significant move up, domestic market valuations still look reasonable with the forecast for further corporate earnings growth and the potential for P/E multiple expansion. Corporate earnings will, however, come up against tougher comparisons in 2011.

Investors should expect volatile equity markets and some sort of market pullback during the year. Three areas that could cause increased market volatility include any renewed weakness in U.S. economic data, potential U.S. municipal budget shortfalls and the European debt situation.

In the Bond Market, interest rates remain at historically low levels, and prices are high. When interest rates rise, bond prices will fall with longer dated maturities likely to fall hardest. While interest rates are not expected to rise significantly in the short-term, they are going to rise at some point as the economy improves and the U.S. Government continues to borrow money. As such, a bond portfolio that is concentrated on the short end of the yield curve seems to be prudent at this point.

Murray Investment Management

If you would like help with establishing an investment plan or would like to schedule a portfolio review, please give me a call. Also, please pass along my name to anyone that may be in need of investment advice.

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