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FEATURED

Economic Update

John Beuerlein

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ECONOMIC UPDATE

**John C. Beuerlein**  
Chairman,  
Chief Investment Officer

### The Economy and Markets in 2011

Investors enter 2011 with slightly more optimism than a year earlier. Some of the uncertainties that were of concern in 2010 have been resolved – the election of 2010 and the extension of Bush tax cuts – but many more issues have been pushed into 2011 and remain risks to any outlook. Nevertheless, after overcoming a soft spot in economic activity that developed in the middle of the year, 2010 ended with a string of generally stronger-than-expected economic reports. It has been our expectation that this recovery would be frustrating to most in its inability to develop much sustainable momentum.

Lacking a catalyst to increase demand (via improved employment) the balance of the current data continues to point to a continuance of a below trend recovery – not a double-dip recession.

We will start with a few observations regarding economic fundamentals, articulate some of the risks we perceive, and follow with our thoughts on the investment markets for 2011.

### The Economy

- The economy appears to have emerged from its summer soft patch. Nevertheless, the economy shows few signs of a meaningful acceleration as unemployment remains chronically high.
- Weak income growth and high unemployment are constraining spending, particularly as households are focused on paying down debt. Until there is improvement in the employment picture, expect consumption to stay subdued.
- Leading Economic Indicators have rolled over and signify that the momentum within the economy has started to ebb. Nevertheless, growth is likely to remain fairly solid. The large gains seen in the first half of 2010 are unlikely to be repeated now that pent-up demand has largely been worked through.
- Early indications on 4th quarter 2010 are encouraging with decent gains in retail sales; however, sustained improvement in consumption is dependent on improving job growth.
- For the second year in a row, there will be no cost-of-living increase in January for the 58 million people receiving social security. The recent gains in gasoline and food prices mean that household incomes won't stretch as far.
- Accommodative monetary policy and fiscal policy should enable the nascent improvement in employment to continue and enable the economy to grow at approximately 3.25% in 2011.

### Inflation

- Core inflation continues to be subdued in the U.S.; however, some pressures are developing in the emerging economies of the world which have had the strongest economic growth. So far, most of the increasing inflationary pressures are due to increasing food prices. Some central banks are starting to tighten monetary policy in response.
- Meanwhile, deflationary forces remain a significant concern of the Federal Reserve. The Fed will continue to guard against deflation until the excess capacity (both physical capacity and labor capacity) that has been created during the recession is more fully employed.

### Employment

- The employment picture is improving, but the December employment report demonstrates that progress is painfully slow.
- Although the unemployment rate dropped from 9.8% to 9.4%, it may not be sustained. The drop was due to a 297,000 increase in employment on the household survey and a 260,000 decrease in the labor force. The labor force participation rate tumbled to a 27-year low of 64.3% in December from 64.5% in each of the prior two months. Discouraged workers soared to a new record high of 1.32 million.
- The U.S. is not creating enough jobs to generate a sustained and meaningful fall in the unemployment rate. This rate of new job creation is just enough to keep pace with the growing labor force, meaning that the unemployment rate will struggle to fall below 9.0%.
- It will be years before we get back to a 5% unemployment rate. We will need 5-6 years of 2.5 – 3 million jobs a year to get there. We have never had two years in a row like that. Unemployment is still going to be a headwind for some time to come, and that is likely to keep a lid on incomes.

## Corporate Earnings

- Corporate profits remain strong primarily due to continued strength in margins. Margins, however, have little upside remaining. The growth rate of earnings, therefore, may be in the process of peaking. With little, if any, pricing power, the challenge for corporations to overcome expected increases in health care costs and lower productivity will likely pressure margins.
- Corporate cash balances are at their highest levels since 1959. This level of cash should ensure that merger arbitrage will be healthy in 2011, along with some increase of dividends, and the repurchase of company stock.

## Risks

- The European sovereign debt crisis is not over. Although widely recognized by investors and authorities, there is still the possibility that complications could surface that could cause a flight to safety.
- The long-term U.S. debt situation will undoubtedly come to the fore several times during the year as a Republican Congress and the Obama administration butt heads over the correct course of action. For starters, we know that there will be issues about the extension of the debt ceiling in March.
- State and local governments and their constitutional mandates to balance their budgets will provide a headwind to economic activity at the local level. Unfunded liabilities at the municipal level must be addressed and incorporated into the budget solutions.
- The asset class that is the poster child for the beginning of the recession, real estate (residential and commercial), still has many problems that impact the balance sheets of many banks and thus their ability to lend to small businesses.
- The global imbalance due to China's undervalued currency and the resulting inflationary pressures could become a lightning rod that results in trade policy errors.

## Equities and Fixed Income

Improving economic reports, continued strength in corporate earnings, and an abundance of liquidity being supplied via monetary and fiscal policy have resulted in equities moving to recovery highs as we enter 2011. The resulting improvement in expectations for the overall economy has also led to an increase in bond yields that, if continued, will lead to negative returns in bond portfolios. With retail bond holdings near record high levels, we expect bond allocations to be reduced as interest rates move higher, and equity allocations to be increased throughout 2011. Additionally, as equities gain further interest, we expect that cash allocations will be further reduced in favor of equities.

In the equity market, specifically, we favor U.S. equities v. foreign developed equities, cyclical industries v. defensive industries, and growth stocks v. value stocks. To replace part of the fixed income part of the portfolio, we believe that high quality dividend paying stocks can deliver comparable yields to fixed income and provide some upside appreciation potential.

We believe that the cyclical equity market advance that commenced in March, 2009 is still in effect. Market corrections and increased volatility will occur when any of the risks we've articulated move to the forefront, however, we will view these instances as opportunities to move equity allocation to above target allocation levels.

Longer term, the US economy will continue to face the reality of the deleveraging process as a result of the excessive credit creation of the past twenty years. The massive fiscal and monetary stimulus that has been provided will act as a counterbalance to the deleveraging process. Periodic economic disappointments are likely, triggering volatility in the markets. This will also likely slow the move to tighter monetary policy, increasing the chances that interest rates remain low for some time. Regardless, the current path of excessive stimulus is unsustainable, and moving back to more normal policies will be challenging and, most likely, involve further pain at some point down the road.

Finally, the events of the past few years have accentuated the importance of constant vigilance, keeping an open mind, and not becoming locked into any specific scenario. Accordingly, we continue to monitor all of our economic and market indicators on a regular basis so that we can adjust portfolio allocations as conditions may change.

## OUR GUIDING PRINCIPLES

<b>Integrity</b>	The core of who we are and the way we live
<b>Expertise</b>	Knowing our profession and practicing it with passion
<b>Advocacy</b>	Being active champions of our clients' financial interests
<b>Confidentiality</b>	Ensuring client privacy

## INDEX PERFORMANCE THROUGH DECEMBER 31, 2010

	QTD	YTD
<b>Domestic Equity Indices</b>		
S&P 500	10.76	15.06
Dow Jones Industrial Aug.	8.04	14.06
NASDAQ	12.34	18.15
Russell 1000	11.22	16.13
Russell 2000	16.25	26.86
Russell 3000	11.59	16.93
<b>International Equity Index</b>		
MSCI EAFE	6.67	8.38
<b>Domestic Fixed Income Indices</b>		
Barclay's Aggregate Bond Index	-1.29	6.56
Merrill Lynch 1-12 Yr Municipals	-1.98	3.02

*\*Trailing 12 Months*

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