



investment update

Alerus
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stocks: government intervention drives fourth quarter rally

In the summer of 2010, stocks fell as investors feared that the sovereign debt crisis in Greece would spread to other Euro-zone countries and the U.S. economy was headed for a double-dip recession. Government intervention in Europe and the United States helped calm these fears. In Europe, the European Central Bank began purchasing sovereign debt and fiscally strong countries such as Germany and France created a \$1 trillion fund to support weaker countries such as Ireland, Greece, and Portugal. In the U.S. the Federal Reserve announced that it would further ease monetary policy with additional purchases of \$600 billion in government securities. In early December, the Obama administration announced a two-year extension of the Bush era tax-cuts set to expire in 2010 along with payroll tax cuts in 2011—both amounting to an additional \$1 trillion in economic stimulus.

Investors cheered sending the Dow Jones Industrial Average up 11.02% for 2010. The broader Standard and Poor's 500-stock index rose 12.8% and the Russell 2000-index of small company stocks was up 25.3% for the year. Consumer discretionary stocks were the best performers as pent-up demand for large-ticket items such as cars, travel, and eating out returned. Ford was up 68% in 2010. The industrial sector whose profits are dependent on global economic growth was the second best performing sector. Companies such as Caterpillar, Deere, and Cummins whose profits are leveraged to growth in emerging markets and the commodity cycle did very well. The technology sector did not fare as well, but individual companies such as F5 Networks tied to cloud computing (up 146%), and Apple extending its gains in consumer electronics (up 53%) offered solid returns.

International stock markets hurt by the sovereign debt crisis in Europe and policy tightening in China did not fare as well as U.S. markets. The Dow Jones World ex U.S. Index rose almost 10.6% in 2010. In Europe, stock markets of countries with sovereign debt issues known as PIIGS for Portugal, Italy, Ireland, Greece, and Spain were lower for the year. Greece was the worst performing market (down 35.6%), followed by Spain (down 17.4%). Despite these problems the Stoxx Europe 600-index rose 9%. Countries with healthy government balance sheets, strong internal economies, or exports such as Denmark, Sweden, and Germany finished strong (up 35.3%, 23.1%, and 16% respectively).

In Asia and Latin America it was a tale of two markets. China and countries dependant on China, such as Australia and Brazil, were either flat or down as the Chinese government tightened monetary policy to reign in inflation. The Shanghai composite fell 14%, Australia was down 2.6%, while Brazil remained flat. Countries with strong domestic economies and exports to the U.S. and Europe did extremely well. Argentina was up 51.8%, Indonesia was up 46.1%, and South Korea rose 22%.

bonds: solid returns but beginning to lose their shine

Bonds went on a roller coaster ride in 2010 but offered solid absolute and real returns. The 10-Year Treasury began the

year with a yield of 3.83%, sold off in the first half of the year as investors anticipated global growth and inflation with yields touching a high of 4.0% in April. Then as European sovereign debt issues spread and it appeared the U.S. economy might double-dip into a recession, money poured into bonds with the 10-year note hitting a low yield of 2.4% in August. However, during the fourth quarter the economy produced better than expected results and bonds sold off as the Obama administration decided to extend Bush-era tax cuts. The 10-year note ended the year at 3.29%. Government debt offered a respectable total return of 5.5% with TIPS doing slightly better at 5.8%.

Riskier debt outperformed government securities with the U.S. Credit Index AA offering a total return of 7.1% and higher yielding corporates and asset-backed securities doing even better. With the Federal Reserve providing ample liquidity, investors continued their hunt for yield—buying both investment grade and non-investment grade bonds. The spread on investment grade bonds over Treasuries compressed to 1.71% and these appear to be more than fairly priced. The spread on single-B bonds over Treasuries compressed from 10% to 8% in 2010. There is room for additional spread compression in high-yield bonds.

Municipal bonds faced two headwinds in the fourth quarter of 2010. The improving U.S. economy drove Treasury yields higher hurting all types of bonds; and with the Build America Bond program set to expire in December, many municipalities rushed to take advantage of it by increasing supply and pushing yields higher. We believe that yields are now attractive for long-term investors.

commodities: in sweet spot—easy money, emerging market demand, economic recovery

Easy monetary policy from the Federal Reserve and the European Central Bank, plus government reluctance in emerging markets to tighten to protect the fragile global economic recovery sent a flood of cash from hedge funds and pension funds into commodities. The Dow Jones-UBS Commodity Index rose 16.8% in 2010. Demand for continued industrialization in emerging economies also helped propel prices.

Precious metals such as gold rose 29.8%, platinum was up 21.5% and palladium climbed 97.3%. Investors sought hard assets as a hedge against fears of currency debasement in the U.S. and Europe. Platinum and palladium prices were helped by demand from production growth in the automobile and farm-equipment industries. Agricultural commodity prices shot up due to weather problems around the globe. There was drought in Russia, flooding in Pakistan, and dry weather in South America. Corn prices rose 51.8%, coffee was up 76.9%, and wheat gained 46.7%. Oil prices remained steady for most of the year buffeted by slow growth in the U.S. and Europe and growing demand in emerging markets. However, as the U.S. economy began to turn in the fourth quarter, oil prices rose—ending the year up 15.2% at \$91.4/barrel. Global oil demand rose to an all time high (87.5 million barrels a day) and is expected to rise in 2011. Natural gas on the other hand was the worst performing commodity—down 20.9% for

the year. Excess supply and weak demand due to high unemployment in the U.S. hurt prices—this trend is not expected to reverse in 2011.

real estate: bouncing along the bottom

Home prices fell 3% in 2010 and have fallen 35% since their peak in 2006, according to the S&P Case-Shiller index. However, the pace of decline has slowed and house prices appear to be bouncing along the bottom. Mortgage delinquencies have peaked. Large price declines and low rates have made housing more affordable than we have seen in a long time. However, housing continues to face risks. The inventory of unsold homes continues to be high at ten months, foreclosures are at elevated levels, and about one-quarter of homeowners owe more than their homes are worth.

In commercial real estate vacancy rates continue to be near historic highs—10.9% for retail and 17.6% for office buildings. The pace of construction for commercial real estate is falling which should help the supply-demand balance. But for both residential and commercial real estate the key to recovery is a recovery in jobs. Job growth will help fill empty offices, malls, and homes.

currencies: from Euro to emerging markets

Nothing illustrates today's investing environment more than the fate of the Euro compared to currencies of emerging market countries. The Euro is a common currency of the European union that has no central fiscal authority. As a result, when the sovereign debt of PIIGS countries came under pressure because of big budget deficits, crippled banking system, or real estate gone sour, European officials failed to get ahead of the problems. Solutions put forward will be tested in 2011 as Portugal and Spain come to the debt markets. As a result the Euro slid 6.6% against the dollar despite the Fed's easy money policies. On the other hand, investors unwilling to accept low yields in the West sent money to emerging markets with strong currency reserves and high growth economies. The Brazilian real, Australian dollar, Thai bath, and the South African rand all rose against the U.S. dollar and the Euro.

2011 outlook: risk assets should outperform

We believe that the U.S. economy, the largest in the world, should return to normal and possibly above-trend growth in 2011. Growth will be supported by a declining rate of consumer de-leveraging, the Federal Reserve's purchase of \$600 billion of government debt, the Obama-McConnell tax cuts, and exports to fast growing emerging market countries in Asia and Latin America. Housing and state government budgets however, will continue to drag the economy down. Economic growth should begin to alleviate the nation's unemployment problem and this rate should tick down closer to 9%. This level of unemployment suggests that capacity utilization will continue to be low and hold core inflation at current levels of below 1%. We expect the Fed to be on hold until 2012.

The previously described environment of above-trend growth, low inflation, and Fed support will benefit equities over fixed income and cash. Therefore, we recommend an overweight position in equities. Within equities the economically sensitive sectors such as technology, energy,

and financials should outperform. We also favor stocks of large multinational U.S. companies such as McDonalds, IBM, Oracle, Proctor & Gamble, United Technologies, DuPont, and Boeing. These companies have excellent balance sheets, access to credit markets, growth in emerging markets, and reasonable valuations. We expect these companies to outperform most other financial assets over the next five to seven years.

With inflation expected to remain below target, the Federal Reserve will be on hold until 2012. This should provide an anchor for short-term rates. As economic growth begins to accelerate in the second half of 2011, long-term rates should drift higher. We expect the 10-year note to yield between 3.5% and 4.0% by the end of the year. This drift to higher rates should limit fixed-income returns to low single digits for 2011. Within the fixed income categories we would be overweight in riskier sectors such as high-yield and asset-backed securities and underweight in government debt.

Within international markets we favor European stocks over stocks of emerging market countries. While the peripheral European countries are subject to sovereign debt risk we anticipate that core countries like Germany and France will ride to their rescue. European stocks are cheap relative to their U.S. counterparts and when the debt crisis clears money should flow into European equities. On the other hand, many emerging markets are experiencing higher than normal inflation. This could force policy makers to tighten monetary policy in these countries similar to what happened in China in 2010. This would hurt emerging market stocks as investors wait for tightening to end.

Interest rates are at historically low levels and housing prices are down 30-35% from their peak. We believe this is an excellent time to buy a new home or trade up to a more expensive home. Low rates in the U.S., Japan, and Europe and demand from emerging markets and investors should all support commodity prices. We recommend an overweight position in commodity assets and gold. The European sovereign debt issues are expected to reappear in Spain and Portugal in 2011. With all the uncertainty around their resolution we would underweight the Euro and overweight the dollar and emerging market currencies.

Clearly, favoring risk assets over government debt presents several risks. The main risk is high inflation in China and other emerging market countries that forces their governments to restrict monetary policy. Emerging markets have been the engines of growth and a severe slowdown in these countries would push investors to seek safety in Treasuries. The upside risk is that the economy may do better than anticipated. An improving job market and spending on big-ticket items will lead to higher inflation and force the Fed to raise rates sooner than the market anticipates. This would move money from bonds and stocks into cash and cash-like safer instruments or to international markets where conditions might be more benign.

Sources: Wall Street Journal, Bank of America Merrill Lynch, Goldman Sachs

We invite you to visit our website at alerusfinancial.com/taxguide to review the 2011 Tax Planning Guide. This guide provides key insight into:

- New tax law provisions
- Capital gains and losses
- Traditional and Roth IRAs