January 4, 2011

A Very Acceptable Follow-Up

At the beginning of 2010 not many investors were expecting to top 2009's 23.5% gain in the S&P 500. The mood on Wall Street was decidedly gloomy at the halfway mark as the index surrendered just over 8% in the first 6 months. The market then proceeded to produce a rousing 23% gain off the early July closing low, leading to a respectable advance of 12.8% for the year. The market's ability to focus only on good news and shrug off any shred of bad news paved the way to a solid double digit gain, at least for those patient enough to wait it out. Given the subpar strength of the economic recovery, we consider this a very acceptable and welcome follow through to last year's performance.

One of the more remarkable stories of 2010 was the performance of the bond market. Keeping in mind the fact that money seeks opportunity; the Federal Reserve Board's policy of near zero interest rates for an "extended period" drove rates down, keeping returns on money market funds at near zero. Seeking an alternative, investors flocked into bond funds, further driving down interest rates, and in early October the 10-year Treasury Bond yielded less than 2.4%. The Fed's goal all along has been to revive the severely depressed housing industry as well as spur job creation, thus resulting in a more robust economic growth picture. Alas, despite near zero rates neither aim was accomplished, as unemployment remains just under 10% and housing continues to scrape along the bottom.

Fresh out of interest rate ammo, the Fed reloaded with Plan B. On November 3rd a program known as "quantitative easing" was implemented whereby up to $600 billion of government issued and other securities would be purchased on the open market. The purpose of this plan is to flood financial institutions with capital, thereby providing liquidity and promoting lending in an attempt to stimulate the economy. While it is much too early to judge the overall success of the program, this strategy has caused an exodus out of bonds, reversing the early trend, and has driven interest rates sharply higher, the exact opposite of the desired effect. The 10-year Treasury has risen over one full percentage point in less than three months, with mortgage rates ticking higher in tandem. A rocky start for QE2 for sure, but the only option for now and one that bears close watching.

Elsewhere we remain enthusiastic about the growth of the global economy. Companies who have invested wisely overseas are being rewarded with profits as under developed countries become more industrialized. While startup costs for offshore operations may be high, strategic collaboration with foreign partners allows US based companies to participate in the growth of emerging nations. Experienced managements within established companies have, in many cases, been able to drive revenue and earnings growth despite the slow recovery here in the US. This trend has been a major investment strategy for us for some time, and will continue to be so in 2011.

Going into 2011, there are always two sides, at least, to every investment outlook. On the plus side, tax rates on capital gains and dividends will not go up until at least 2013, extending the cuts enacted by the prior administration. In addition, 2011 will see a 1-year holiday reducing the social security

tax from 6.2% to 4.2%, putting more money in the hands of consumers. Consumer confidence and the index of leading economic indicators remain in positive territory, reflecting optimism that the rebound will continue into the New Year. Investor concerns center on the high unemployment rate and a housing industry that cannot find firm footing. Throw a burgeoning federal budget deficit, higher oil prices, and tension in the Middle East into the mix and there is plenty to worry about, which by the way is often the wall that markets climb rewarding long-term investors.

At this time last year we cautioned that corrections can be a good thing for the financial markets. After a dismal first half, all of 2010's gains came in the second half of the year, and we would be remiss in not pointing out that similarities exist between then and now. The stock market is due for a pause at some point, and any pullback in prices will allow those who have missed the advance an opportunity to get in. There is still plenty of cash on the sidelines, and all that money coming out of bond redemptions could well find its way into equities. As we have always done, we will "stick to the basics" and invest for the long haul.

As the New Year begins, we are also pleased to announce that Abbot Financial was chosen as a Boston Magazine FIVE STAR Wealth Manager for 2011. FIVE STAR is an exclusive award given to only seven percent of professionals in a given industry and market area based on research with clients, peers and industry leaders.

Bill, Andrew, Bob and Chris wish each of you and your family a healthy and prosperous new year, and we look forward to speaking with each of you in the near future.

Year End Scoreboard 2010

Dow Jones: +11.0%

S&P 500: +12.8%

Nasdaq: +16.9%

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