

2010 FOURTH QUARTER COMMENTARY



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The Financial Markets

- ◆ Improving domestic economic data combined with growing international economies fueled a strong year-end advance in global equity markets, while fixed income markets retreated under the pressure of higher interest rates. In spite of evidence of strengthening employment and solid corporate earnings, there are continued concerns of weakness in the housing markets, European sovereign debt, burgeoning federal budget deficits and looming state and local budget cuts.
- ◆ Domestic equity markets had a good year, continuing the rally off the March 2009 bear market lows. The S&P 500 Stock Index rose 10.7% for the quarter and 15.1% for the year, while the Dow Jones Industrial Average was up 8.1% for the quarter and 14.1% for the year. Smaller stocks outperformed, with the Russell 2000 Index up 16.3% for the quarter and 26.9% for all of 2010. Returns were strongest in the Energy, Materials and Consumer Discretionary sectors, while the Utilities and Healthcare sectors lagged.
- ◆ International equity markets struggled but were still positive, as the sovereign debt crisis in Europe and a rise in reserve requirements in China dampened relative returns. The MSCI EAFE Index rose 6.6% for the fourth quarter and 7.8% for the entire year. The MSCI Emerging Market Index was up 7.3% for the quarter and 18.9% for the year.
- ◆ Commodities were propelled by strong global economic growth (ex. Europe, Japan, U.S.) and a flood of cash from hedge funds and institutions. The DJ-UBS Commodity Index rose 16.8% in 2010, which is still 11% below its 2007 year-end close. Copper and gold prices are at all-time highs, while oil is at a 27-month high. Agricultural goods, cotton and other metals have also been strong.
- ◆ The Federal Reserve Bank maintained its pledge to keep short rates near zero for an extended period, and commenced a \$600 billion program of Treasury bond purchases, providing additional monetary stimulus for the economy.
- ◆ Treasury bond yields climbed about 0.80% in the 5-10 year maturity range, reversing the previous quarter's bond rally. The sell-off in bonds began in early November following the Fed's announcement of its widely anticipated quantitative easing plan. The 10-year Treasury note ended the year at a yield of 3.29%, after dropping to a low of 2.39% in early October. Most investment-grade fixed income indices posted negative total returns for the quarter. Corporate bond credit spreads tightened as equities rallied; corporate yields rose less than Treasury yields, resulting in corporate sector outperformance. High yield debt continued to rally. The Barclay's Aggregate Bond Index was down 1.29% for the quarter and up 6.55% during 2010.
- ◆ The pace of economic growth picked up in the fourth quarter, and investors shifted away from low-yielding bonds into riskier assets such as stocks. Bond mutual funds saw net outflows in December after nearly two years of heavy net inflows.
- ◆ Municipal bonds declined as a surge in supply from the primary market coincided with investor selling in the secondary market, resulting in sharply higher yields. Long maturities suffered the most as the Build America Bond program was not extended, thus the markets are expecting more tax-exempt issuance in 2011.

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The Economy

- ◆ Signs proliferate of a spreading economic recovery. The manufacturing and service sectors are meeting or exceeding forecasts, while the housing sector continues to be weak.
- ◆ The surge of new factory orders and decline in inventories during December reversed a recent negative trend. Manufacturing expanded in December at the highest pace in seven months, driven by domestic US demand and exports. Virtually all the components of the U.S. ISM Factory Index – new orders, production, manufacturing headcount and the prices index – were up for the month.
- ◆ The number of people applying for jobless benefits fell in December to the lowest level since July 2008. This was followed by lower indicated layoffs and firings, a strong December ADP jump in private payrolls and, in the last week of December, an actual decline of 47,000 in the number of people receiving jobless benefits. The employment picture is slowly improving.
- ◆ The annual percent change in personal consumption expenditures (ex. food and energy) are at all time lows. The cost of energy continues to take a higher share of the budget, while food prices are on the rise again due to rising commodity prices. Levels of consumer credit continue to decline helped by consumer debt reduction and banks' reluctance to lend.
- ◆ The consumer showed resilience during the holiday season, as retail sales rose 5.5% for the period, the largest increase since 2005. Apparel and jewelry sales were strong. Electronics lagged as lower flat panel TV prices dampened sales revenue. Auto sales surged to 12.26 million units in December, the best sales month since the Government's "Cash For Clunkers" program in 2009.
- ◆ Construction spending rose in December for the second straight month as architectural billings indicate stabilization in both residential and private non-residential structures.
- ◆ The housing market is still adjusting to the effects of the expiration of the first-time home buyer tax credits. In October, nationwide housing prices fell 1.0% from the previous month, and 0.8% year-over-year after being up in September. For November, the number of contracts written to buy previously owned homes increased for the fourth time in five months. Prices will continue to be pressured by a large shadow inventory of properties headed for foreclosure.
- ◆ International economies (ex. Europe and Japan) continued their growth. Since the later 2000's, emerging market economic growth has consistently been about 4% per annum better than the developed world. As the overall rate of growth has slowed from last year, emerging market economies are still maintaining this advantage.
- ◆ European manufacturing exceeded growth expectations in December while China's purchasing managers' index showed a slowing rate of growth. Chinese monetary authorities are tightening monetary reserves to dampen inflation while other authorities crack down on real estate speculation and close factories with higher levels of emissions and inefficient energy usage.
- ◆ Interest rates are rising in many countries to quell inflation and overheated real estate values.

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2011 Outlook

Despite a broad rebound in equity markets during 2010, we continue to prefer risk assets at the outset of the New Year. The recent sharp run-up in equities combined with optimistic short-term sentiment measures, concerns about European sovereign debt, and worries over monetary tightening and slower growth in China could certainly prompt a temporary pullback. In our mid-year market review, we wrote about staying the course during the equity correction that began in April. At that time, our view of the equity markets from the perspective of sentiment, interest rates/credit conditions, leading indicators/earnings, and valuations suggested that the pullback was offering investors an opportunity. As we will discuss in more detail below, other than overly optimistic short-term sentiment measures, we believe that these indicators continue to tell the same story today.

The move in equity markets in 2010 was driven by a surge in corporate profits with S&P 500 earnings rebounding about 35% to \$84. Valuation multiples contracted from 14.2X forward earnings to 13.2X at the end of the year. 2010 was the second year in a row where beta outperformed valuation and quality measures. Typically, as earnings growth starts to moderate, more traditional measures like quality and valuation begin to drive performance.

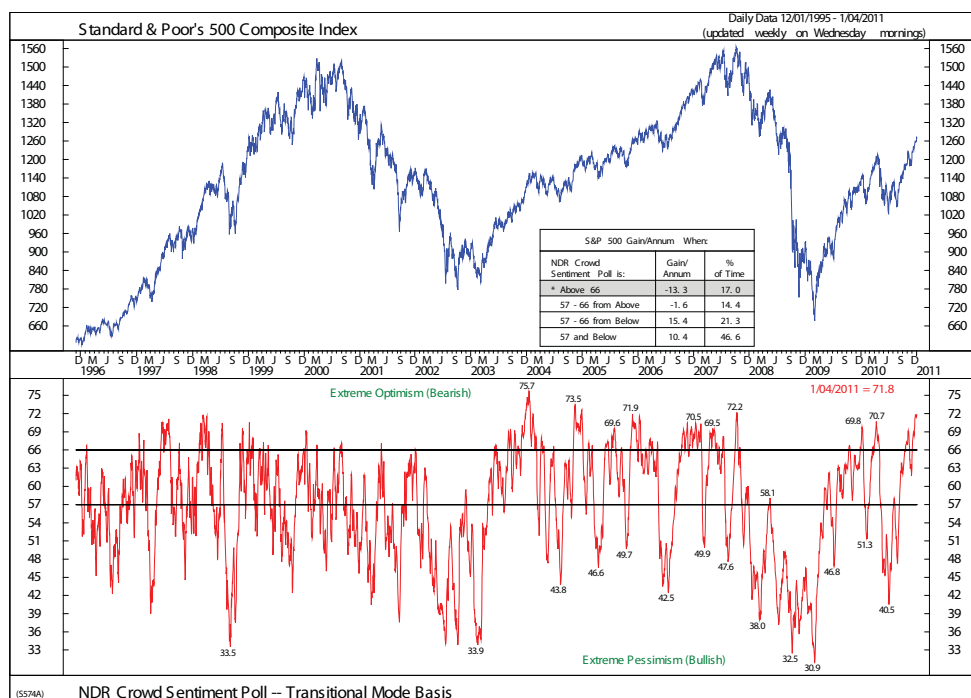
Three significant structural problems that are forefront in investors' minds will need to be monitored. The first is the sovereign debt problems in Europe and the longer term viability of the Euro. The second is the massive U.S. fiscal deficit and the fiscal challenges at the state and local level. The third major concern is the global imbalance centered on China's undervalued currency and the link to its increasing levels of inflation.

While we remain cautiously optimistic, it is also important to note that significant risks remain to the cyclical improvement we are seeing in the economy today. The recovery has come with a hefty price tag, and policy makers will need to strike the right balance between their efforts to sustain growth and the need to reduce deficits.

Sentiment

Equity markets have historically performed best in year three of a Presidential cycle, especially in the first six months of the year. On the negative side, since WWII there have been ten back-to-back double digit advances like we have just experienced in 2009-2010. Only twice (1951 and 1994) did the streak run to a third year, and the average return in the third year was 1.7%.

Investor sentiment has become very optimistic in the short term, suggesting that the equity market may pause or correct some of the advance enjoyed in recent months. The Ned Davis research poll to the right shows the shifts in investor sentiment that have occurred in recent years.

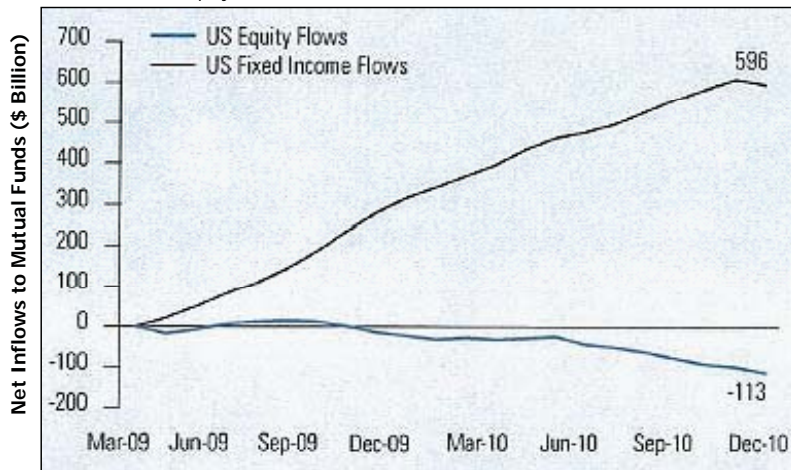


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Cumulative US Mutual Fund Flows Since Market Bottom in March 2009

Despite the S&P 500's almost 90% rally since the trough, investors have pulled over \$100 billion out of US equity mutual funds.



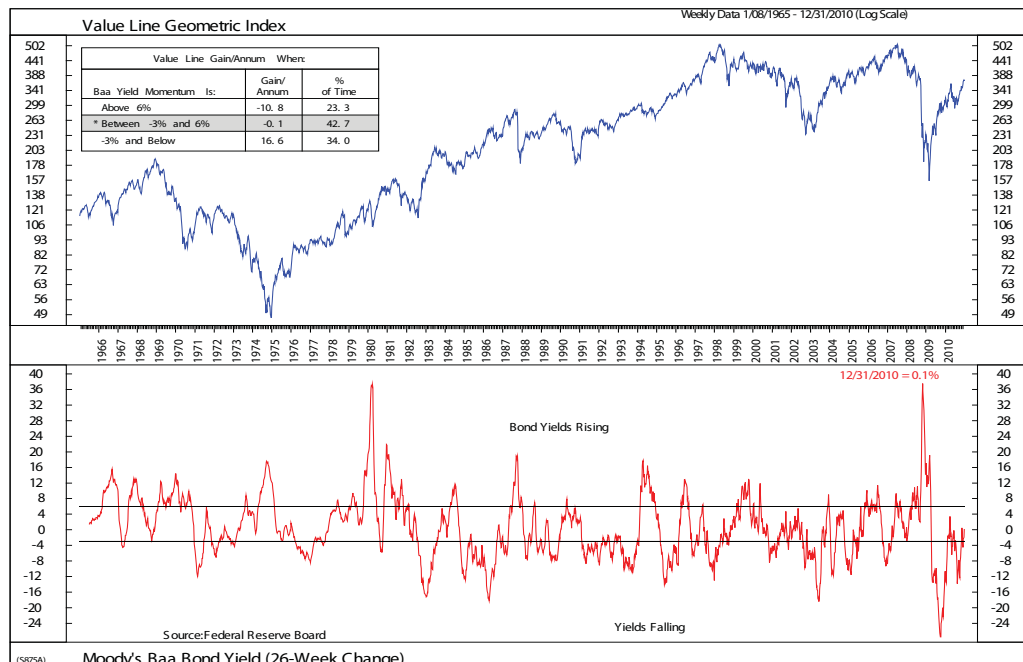
Data as of December 21, 2010

Source: Investment Strategy Group, Datastream, ICI

From a longer term perspective, it is hard to make a case that investors are overly optimistic about equities. Despite the equity market rally since March 2009, investors have pulled \$100 billion out of U.S. equity funds. Following this steady outflow from U.S. mutual funds, investors began to add money late in the year. Historically, the flow of money back into equity funds has been driven by three factors that may well occur this year: confidence in the economic recovery, negative returns in bonds as interest rates normalize, and higher equity prices as investors chase returns.

Interest Rates/Credit

The yield curve remains extremely steep, suggesting an environment that is supportive of economic growth and higher equity prices. The recent move up in interest rates reflects stronger economic reports from across the globe. While not yet a threat to equities, it will be important to monitor the move in rates during the year. As seen in the chart below, a rapid rise in interest rates has historically provided a significant headwind for equity performance. We believe it would likely take a move above 4% in the 10-year Treasury to cause problems for equities.



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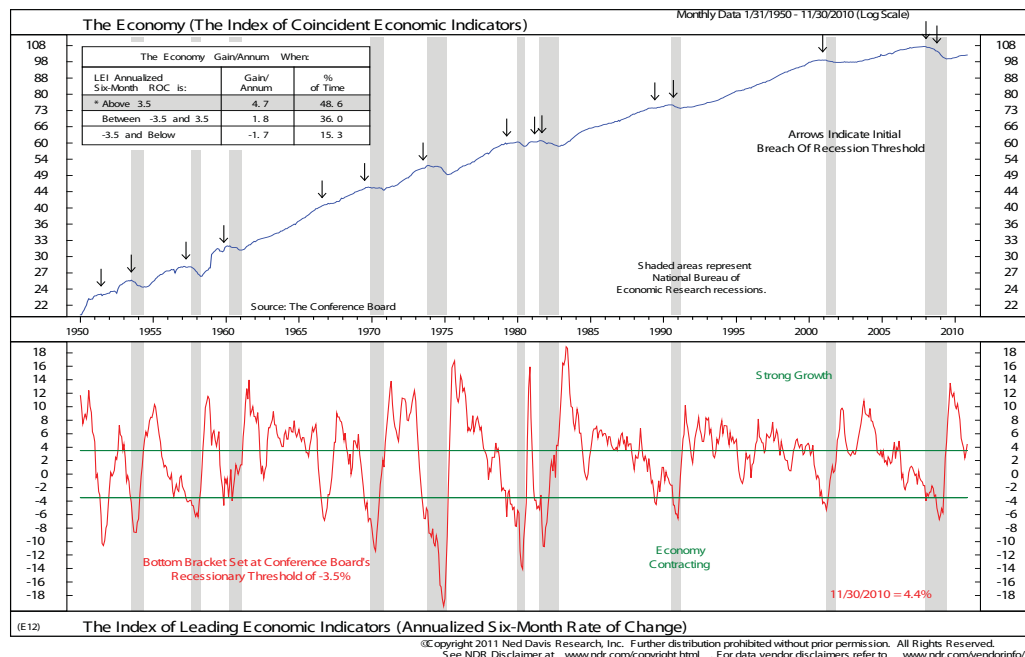
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This year we may see the beginning of the normalization of interest rates as better economic growth and heavy Treasury borrowing are likely to work against Treasury securities in 2011. The Federal Reserve's plan to buy bonds through the middle of the year and their pledge to keep rates low on the short end of the yield curve for an extended time will likely moderate the rise in interest rates. We are maintaining shorter durations in bond portfolios and remain more willing to take credit risk than interest rate risk. We are underweight Treasury securities and overweight corporate bonds, although the valuation case on the credit side has become less compelling. Spreads on investment grade corporate bonds are closing in on longer term averages and spreads on high yield bonds are modestly above their long-term averages. Despite tighter spreads, support for further modest spread compression and the outperformance of credit oriented securities seems likely due to strong balance sheets, a continued need for income, and the potential for higher Treasury yields.

Municipal bonds underperformed taxable bonds last year primarily due to the selling that occurred in the fourth quarter. Tax-exempt debt showed relative value at the end of December, though absolute yields are still low by historic measures. State and local government budgetary pressures will continue to make headlines, yet we believe that safe sector credits remain suitable for conservative investors.

Leading Indicators/Earnings

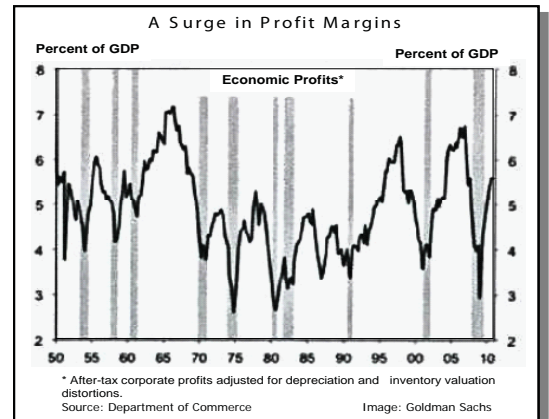
Most forward looking economic indicators have strengthened since their pause during the middle of the year, and now indicate a stronger economy in 2011. This is supported by recent readings of the Leading Economic Indicators (shown below), which have again reached levels suggesting faster economic growth.



Earnings have continued to surprise on the upside over the past seven quarters, driven by historically strong profit margins. At this point in the cycle, a key concern for investors becomes what happens when profit margins revert back to more normal levels. Typically, margins do not peak until 3-5 years after a recession. The slack in the labor market suggests that wage pressures are not likely to threaten margins and earnings as long as economic growth holds up. The move up in commodity prices will be important to monitor for the impact that higher input prices could have on margins. Several structural reasons are likely to support margins at these levels unless economic growth rolls back over. Earnings generated from international sources now make up 40% of S&P 500 earnings and generate higher margins. Lower interest rates and lower corporate tax rates have contributed to structurally higher margins and are unlikely to significantly reverse in the near future.

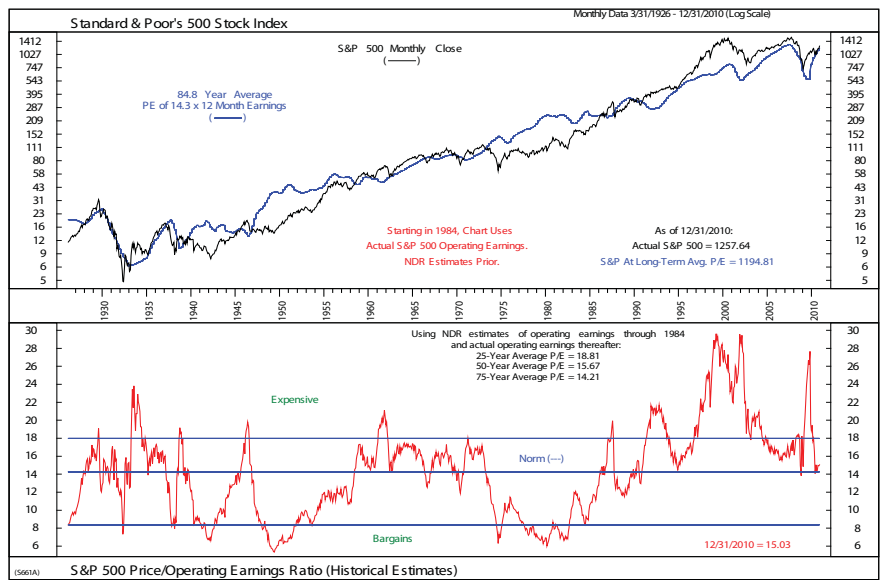
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Estimates continue to be revised upward and analysts are now forecasting approximately 13% earnings growth to around \$95 for S&P 500 companies. Since it appears that S&P 500 earnings will likely be running at an annualized growth rate of almost \$90 when 4th quarter earnings are reported, this estimate does not look as aggressive as it did a year ago. However, with profit margins rapidly returning to their highs, there is less room for continued upside surprises. Earnings growth around the world is forecasted to increase almost 15%.



Valuation

The S&P 500 closed the year trading at 13.2X forecasted earnings for 2011, while Lowe, Brockenbrough's core equity portfolios trade closer to 12X estimated earnings. These valuation levels compare favorably to an average of approximately 15-16X earnings in recent history. The chart from Ned Davis Research on the right shows the valuation of the S&P 500 on a trailing operating earnings basis. At 15X earnings, the market is trading in-line with long term averages and at a discount to more recent history. While we remain cautiously optimistic on equity markets for 2011, we are not convinced that valuations will expand significantly beyond their historical averages of 15-16X earnings. There is certainly historical precedent for this to happen in an environment with low inflation, accommodative policies, and somewhat improved economic growth. However, we expect multiples may remain slightly below average in the aftermath of the financial crisis and the uncertainty surrounding the unwinding of extraordinarily accommodative monetary and fiscal policies. The chart to the right, which shows the forward P/E of the Morgan Stanley Global Equity Index, suggests that equities remain attractive on a global scale.



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