

FOURTH QUARTER REVIEW

Will the person who took all of the trends please put them back where they belong?

The S&P 500 finished nearly flat for the entire year. But how the market got there is another story entirely! This past year was full of major events and stories that caused global markets to gyrate wildly throughout the entire year. The first half of the year was very good for relative strength strategies. That was followed by a very steep selloff during the summer. The last part of the year consisted of a trendless market that ground sideways in a very volatile trading range.

Europe continues to be a large problem in investors' minds. There are definite problems there that could very well lead to the end of the Euro as a unified currency. The good news is the problems have been known for quite some time. It also seems that, despite the muddled political process, European governments are committed to fixing the problems so that capital markets are not totally disrupted. How long that process will take is totally up in the air, but it beats the alternative of not having any confidence the problems will get fixed. Investors will also grow tired of the European issues. As time goes on, many of the problems will still remain but investors will begin to care less and less about them. We will learn to live with the situation like we do with all of the other long-term problems that markets have conquered over time.

Our economy is improving, but not nearly as fast as people would like. Consumer Sentiment rose for the fourth month in a row in December. Initial unemployment claims have started to fall off rapidly and the unemployment rate is starting to decline. But there are still many obstacles to growth that are preventing us from seeing a better business environment.

Some of these obstacles are undoubtedly political. We are moving into the election season and politics seem more partisan than usual. We've also witnessed more than the usual allotment of

dysfunction, with lawmakers unable to compromise on the debt ceiling this summer—a problem that led to the loss of the AAA rating for U.S. government debt. However, the immediate impact of the U.S. debt downgrade was a rally in Treasury bonds!

All of this has led to very poor investor sentiment. Every survey we look at shows investors are very wary, and don't have the risk appetite they normally have. This has been reflected in a couple of ways. The first is the very choppy and volatile environment we are seeing. Investors' low confidence is causing them to overreact to every piece of news for fear that the latest piece of news will be "the big one." That is causing the risk on / risk off trade you hear so much about as well as the unusually large number of days where the market moves 1% or more. What investors are buying are all of the non-volatile assets. There have been huge inflows in minimum variance equity products, and high quality dividend strategies performed very well at the end of the year.

The second thing the poor sentiment has done is make it difficult for trends to develop. The mindset is extremely short-term right now. As soon as trends begin to asset themselves investors look for any warning sign they can find to sell, and the trend runs out of fuel. These conditions happen periodically, but they have always resulted in trends emerging from the trading range. We are never sure what those trends will be, but we have absolutely no reason to believe that this time will be different and we will be stuck in a trading range forever!

If you are looking to put money to work in relative strength strategies, now is the time to do it. It is always easy when we are "on trend" and have the themes that are working in the portfolio. However, trendless markets mean-revert to trending markets. With any hint of economic improvement, 2012 may be a much better year than investors currently expect, and that could lead to some very dynamic trends.