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The Good, the Bad, and the Ugly of 2010-2011

Good, bad, ugly – 2010 showed us all three faces: stock market rallies at the start and finish, precipitous months along the way; and both a steep equity “flash crash” in the Spring (which proved to be more flash-in-the-pan but perhaps also a warning worth heeding about what can go wrong when high frequency trading algorithms hit a moment’s vacuum in the bid) and a quick bond rout to end the year.

Point-to-point, though, 2010 wound up emphatically well, with annual total returns of 15.1% for the S&P 500 (including dividends) and 6.6% for the Barclay’s Aggregate Bond Index.

Now, with 2010 slipping behind us, let’s take a big picture look as 2011 sprawls ahead.

It is **good** that intervention by central banks worldwide has kept economic chaos at bay so far; it is **bad** that the costs of doing so will slow the pace of global recovery and burden the developed world with higher taxes and/or greater inflation going forward; it will be **ugly** if international policy coordination falters or beggar-thy-neighbor currency wars spread, or if domestic challenges cause leaders to forsake what’s left of international free trade in favor of political expediency.

It is **good** that you can earn higher interest on bond purchases now than you could a few months ago; it is **bad** that the flip side of profitable saving/lending is more expensive borrowing; it will be **ugly** if yet higher rates weigh on spending in general and further squeeze housing prices in particular.

It is **good** that federal capital gains and dividend tax rates will remain low for another two years; it is **bad** that state and municipal budgets are so far underwater that non-federal taxes will go up instead; it will be **ugly** if neither spending cuts nor revenue hikes cover the gap, and the term “strategic default” applies not just to homeowners tired of being upside down on their mortgages, but to fiscally beleaguered cities and counties too.

It is **good** that we’re in America; it is **bad** that America’s debts and trade deficits make us depend so much on goodwill abroad; it will be **ugly** if that goodwill, expressed foremost as confidence in the US dollar as the world’s reserve currency, is no longer forthcoming.

But let’s turn it around: While it is **bad** that the officials making critical macroeconomic decisions seem more than a half-step behind private interests to whom they’ve turned for help in buoying the markets, and **ugly** that trust in our “powers that be” has plunged so low, still it is **good** that our system of political economy is **not** utterly corrupt, just fitful and ham-handed, yet capable eventually of getting things right in spite of itself.

While it is **bad** that the stock market is broadly expensive on a normalized basis, and it could get **ugly** if corporate profit margins (now near all-time highs) revert to their historical trend absent major gains in the top line (sales), it is **good** that our equity sweet spot – high quality stocks with a practice of raising their dividends at a rate greater than inflation – is attractively priced relative to just about everything else.

And speaking for our little corner of the world here on the banks of the Willamette River, it is **good** that at Allen Trust Company we get to do work we enjoy so much; it is **great** that we get to do it as a part of a wonderful team; and it is **beautiful** that we get to do it for you.