

Past (2010)

Last year could be considered the year of the negative news cycle. Widely reported stories last year included the BP oil spill, the May 6 Flash Crash, a continued high unemployment rate, concerns surrounding the Eurozone as a going concern, fears of a double-dip recession, earthquakes in Haiti, volcanic eruptions in Iceland, and a contentious midterm election season. Despite these negative headlines, equity markets enjoyed strong returns. In fact, all major asset classes ended the year higher, including domestic and international stocks, real estate, bonds, and commodities. Ignoring headlines served investors very well in 2010.

Underneath these negative headlines, things were improving as the economy spent most of 2010 in continued recovery mode. For the year, Initial Jobless Claims trended lower, Industrial Production steadily rose, GDP reports showed modest growth in the economy, and corporate profits continued to trend higher. All of these factors were not lost on the Federal Reserve, which noted at their December meeting that “economic activity was increasing at a moderate rate...”

All the positive returns for equity markets occurred in the last four months of the year. The foundation of the rally was partly attributed to a speech on August 27 by Fed Chairman Ben Bernanke. In the speech, Bernanke detailed alternative strategies the Federal Reserve could use in order to spur economic growth outside the traditional monetary policies used in the past. With the fed funds target rate at 0%, many observers pointed specifically to his remarks concerning the strategy of the Federal Reserve to expand its balance sheet by purchasing longer-term securities, namely government debt. The strategy and ultimate goal of the move was more plainly summarized in a speech several weeks later by an executive in the New York Federal Reserve Bank when he noted that, “Balance sheet policy can still lower long-term borrowing costs for many households and businesses, and it adds to household wealth by keeping asset prices higher than they otherwise would be.” This explicit acknowledgement by the Federal Reserve that it was targeting asset prices through balance sheet policies outside the traditional scope of monetary policy tools ignited prices across all risk assets through the remainder of 2010.

Present (January 2011)

Given the above economic backdrop and the expectation of higher interest rates, our current positioning of asset allocation within fixed income is limited exposure and reduced weighting in longer-term bonds. However, sectors of the fixed income markets are still attractive, such as high yield and emerging debt, but duration risk is much more of a concern than credit risk currently. Cash levels are being kept to a minimum and any allocation to money market instruments is for defensive posturing only.

After reaching record levels in 2009, volatility in equities has dropped substantially. This return to normalcy has also occurred globally across markets, including commodities and currencies. The implication here is that with a more normal volatility picture, there also should be a return to a more normal rally-correction cyclicity. This suggests that there may be a short-term correction approaching but would be followed by the resumption of the longer-term uptrend.

Also returning to normalcy is the anomalous positive correlation between stock prices and bond yields, a sign that the abnormally high levels of deflation fear have started to ebb. Equity investors will be likely to see rising bond yields less as a positive reflection of economic growth and more as a

negative sign of increasing inflation expectations. At some point in 2011, this implies rising interest rates will start to have a negative impact on the stock market trend. Until this evidence occurs, however, we will stay with the uptrend as the normalization trend continues and maintain our bullish equity sentiment.

Given this bullish stance on equities, we are maintaining an overweight in mid cap companies specifically. Small cap and mid cap companies should continue to outperform large caps until a broad correction occurs. Furthermore, domestic companies are preferred to international stocks as European debt concerns remain and a stronger dollar continues. Commodities also remain attractive as they continue their two-year uptrend.

Future

From a macro perspective, the underlying issues that markets and governments have been grappling with over the past couple of years are still present and likely to influence this year. First, banks are clearly still struggling with the aftereffects of the housing bust as evidenced by the FDIC closing over 150 institutions last year, the highest in a single year since the Savings and Loan crisis. The problems that have recently come to light regarding mortgage documentation and foreclosures point to 2011 being a busy year again for the FDIC as weaker banks are merged into stronger institutions.

European government debt dominated the headlines several times in 2010 as Greece and then Ireland took some form of a bailout and were forced to make significant budget cuts. The issues with these nations having too much debt has long been known, but the process of recognition and action has indeed been very slow. The next two problem countries that are seeing their cost of credit rise to new highs are Portugal and Spain. Don't be surprised to see these two receive some form of financial assistance and conduct debt restructuring in the next twelve months. Keep an eye on Belgium as well.

Finally, we expect continued volatility in the equity and bond markets in the coming year as investors swing between optimism about the very real improvements in the economy and fear that the events of 2008 could be repeated. One statistic that investors can watch this coming year is the VIX, or Market Volatility Index, which has now fallen to three-year lows and tends to rise when fear and volatility are increasing. The positive side of volatility is that it creates opportunity: opportunity to buy when others are selling and sell when others are buying. Fear and greed have always governed the market and will again in 2011.

Source of information is Ned Davis Research.

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