

*We enter 2011 under conditions quite similar to those we found at the start of 2010: Europe is too cold, China is too hot, the US is “just right.” Investor sentiment is too bullish. And the big question remains how the US economy will fare absent Uncle Sam’s help.*

### Market Overview: Deus Ex Machina

On August 26 of last year, closing prices for the S&P 500 showed the index down 7% in 2010. US economic growth had slowed from a 5% pace in the fourth quarter of 2009 to less than 2% in the second quarter of 2010. The yield on the 10-year US Treasury Note had plunged from 3.8% to 2.5%, reflecting slowing economic growth and hinting at a “double dip” recession. This was our economy without Uncle Sam.

On August 27 Federal Reserve Chairman Ben Bernanke spoke at a symposium in Jackson Hole, Wyoming, where he indicated the Fed would embark on another round of what is (unhelpfully) called “quantitative easing.” This is where the Fed buys longer dated US Government bonds in an effort to increase liquidity and stimulate the economy. On that very day, the stock market began to rise.

By year’s end the S&P 500 was up 15% for 2010. Economic growth had accelerated in the third quarter to 2.6% and most estimates peg it near 3% for the fourth quarter. The yield on the 10-year US T-Note responded accordingly, climbing back up to 3.4% in anticipation of continued economic expansion.

While we are grateful for the Fed’s *deus ex machina* intervention in the markets and the economy, we’re troubled it was necessary. It means the US economy is still on life support. Of course life support, if necessary, beats the alternative.

### Politics and Sausage

You’ll recall that in July Bernanke told Congress that the economic outlook was “unusually uncertain.” This was economist-speak for “we have no way to predict what lies ahead.” At that point the markets, as described above, suspected an iceberg.

The Fed’s unusual exertions, however, weren’t solely responsible for the turnaround. After the “shellacking” that Democrats suffered at the polls in November, Republicans became complicit in economic outcomes and so developed an interest in actually governing. This led to the ugly deal House Republicans struck with President Obama, whereby they got to extend all the Bush income-tax cuts for two more years while Obama got to extend unemployment benefits for 13 more months and reduce payroll taxes for one year.

While no one on either side of the political aisle seemed to like the outcome, both sides got more than they might have expected. All in all these measures are estimated to create an additional \$300 billion in economic stimulus, about a 40% lagniappe on top of 2009’s original, massive stimulus bill.

### Double Dip Denied

Between the monetary stimulus of the Fed and the fiscal stimulus of Congress, Uncle Sam managed to stoke the economic engines sufficiently to avoid a relapse into recession—the dread “double dip.” A few months ago this was a very live option. That it no longer seems to be explains, at least in part, stocks’ 20% uphill sprint from late August through year’s end. For as investors warmed to the idea that recession wasn’t in the cards, their estimates of 2011 corporate profits rose accordingly.

Of course, this being a market there are two sides to the trade. Skeptics think Uncle Sam has merely kicked the can down the road where we will surely run into it again—in 2012. Optimists accept Uncle Sam’s charity and consider it just the assistance the economy needed to get back on its feet. As ever, time will tell. But for now most investors seem to be enjoying reading their fourth quarter statements.

continues on reverse

Major Market Performance 2010

	4th Quarter 2010% chg.	2010 % chg.
DJIA	8.04	14.06
S&P 500 (large cap)	10.76	15.06
S&P 1000 (small/mid cap)	14.32	26.55
S&P 1500 (all cap)	11.19	16.38
NASDAQ	12.00	16.91
Barclays State G.O. Municipal Bond	-3.74	3.10
Barclays Gov/Credit Intermediate Bonds	-1.44	5.89

### Animal Spirits

There's nothing like a quick 20% pop in stocks to make people feel better. This, in fact, was one of the Fed's objectives in launching a second round of quantitative easing ("QE2"). With consumers aggressively paying down debt, the Fed's ability to stimulate borrowing--and thereby spending--through lower interest rates is limited. But Bernanke knows that liquidity once created has to go somewhere: If the real economy can't absorb it, the financial economy will. Excess liquidity created by the Fed through "QE2" is part of what drove stocks higher.

When people's net worth rises (e.g., from stocks going up) it creates what economists call a "wealth effect," that is, an increase in people's spending resulting from feeling richer. Bernanke was aiming in part for just this effect with QE2--and it seems to have worked.

The downside to all this cheer is that investors today are a bit too upbeat, at least as regards the stock market. Sentiment indicators across the board, from surveys to options traders, show investor enthusiasm at very high levels. As contrarians, we know this often leads to disappointment. Any number of things might trigger a pullback in stocks: a new eruption of European debt problems, more high inflation readings in China, etc. But a little digestive difficulty in the stock market wouldn't surprise us at this point.

### Beggar Thy Neighbor

Another sly goal of Bernanke's return to quantitative easing was its impact on the US dollar. QE lowers interest rates and weakens the dollar as foreign demand flows elsewhere looking for higher yields. No Fed Chairman would admit to such policy objectives, but this aspect of QE2 worked even better than the "wealth effect."

Once Bernanke announced QE2 in late August the US dollar began to fall against other currencies, eventually losing 10% through the end of the year. A weaker dollar makes US exports cheaper, which stimulates foreign purchases of US goods. A pickup in exports played a key role in turning around what was a fading US economy.

As with the wealth effect, however, there's a downside to a weaker dollar. While it makes our exports cheaper it makes our imports pricier--imports like oil, whose price is back over \$90 a barrel with prices at the pump over \$3. The challenge here is that exports count for 12% of US GDP while consumption counts for 71%.

If higher prices at the pump siphon off spending elsewhere, we could lose more in consumption than we gain in exports. This would threaten economic recovery and with it the stock market's upward bias.

### Deja Vu

We enter 2011 under conditions quite similar to those we found at the start of 2010: We have a Three Bears scenario globally with Europe too cold, China and the emerging economies too hot, and the US for the moment looking "just right." Investor sentiment is too bullish for comfort, as it was a year ago. And the stock market's future course again depends in part on how the US economy fares after the government's happy juice wears off.

There are two key differences, however, between now and a year ago. First, stocks are cheaper. Over the past year corporate earnings have risen faster than stock prices, making for a lower price-to-earnings (P/E) ratio than we had last year. At 14 times 2011 earnings, the S&P 500 is trading below its post-WWII average P/E of 16.

Second, the economy is in better shape. Consumer debt has been paid down (though there's further to go). The unemployment rate is down (ditto). Bank balance sheets are stronger. The housing sector is showing signs of healing. And corporate earnings have been stellar. All of these raise the odds of the economy regaining its feet.

### What We're Doing

With the risk of recession off the table, we have moved portfolios to a more neutral, less defensive posture. This means increasing equity exposure and reducing bonds. It also means dialing up our stocks' sensitivity to cyclical factors such as rising commodity prices, e.g., with energy and materials stocks, and dialing back counter-cyclical holdings like utilities and healthcare issues.

As noted above, rising commodity prices--particularly oil--could crimp consumption as higher gas prices drain dollars from other consumer spending. As consumption drives the US economy, we're keeping an eye on oil prices as a potential threat to the fragile US recovery.

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## Social Advocacy Highlights

### Environmental Lending

In the Fall, we engaged with **Royal Bank of Canada** regarding its **environmental lending** criteria, in light of its position as one of the largest financiers of energy companies in the environmentally problematic Canadian oil sands. Our dialogue touched upon the greenhouse gas footprint of the projects the Bank underwrites, how it deals with the potential for irreversible ecological damage, and its willingness to demand that Free Prior and Informed Consent become the standard that its lending clients should implement in their relations with First Nations tribes. (Free Prior and Informed Consent is the right of communities to set their own priorities and limits in negotiation with governments and private actors seeking to commercialize their lands and resources, which includes the right to say 'no.')

While we hope to see the Bank reduce its exposure to projects like the oil sands, we were impressed by its upgrading of internal environmental and social project evaluation policies and so withdrew our shareholder proposal.

### Pebble Mine

The proposed Pebble Mine in Bristol Bay Alaska, if constructed, would be the largest **open pit mining** operation in North America. The mine would produce billions of tons of mining waste, which would be held behind a system of dams equivalent to the Three Gorges dams in China. The dams would be in an earthquake-prone area that serves as the breeding grounds for the largest sockeye salmon run in the world. Not surprisingly a broad alliance of Alaska natives, commercial and sport fishing interests and environmentalists oppose this project. But the fortune to be made in this gold and copper prospect appears to be exerting an irresistible pull on the mining company, **Anglo-American**.

Despite the risk, expense and opposition, the company continues to push ahead with its plans. As investors in many global banks that have financed Anglo-American's mining operations in the past we are concerned not only about the potentially devastating human and environmental impacts of this mine but the financial and reputational risks to the banks if they provide financing to Anglo-American. We have met with two of the banks to make our concerns clear and urge them to stay away from any involvement in the Pebble Mine. In October the head of our California office, Will Lana, went to Alaska to meet with community members and hear their concerns. In the year to come we will urge the Environmental Protection Agency to review the project with its veto power under the Clean Water Act.

### Net Neutrality

Roll Call, the influential newspaper and online publication that covers Capitol Hill, noted in December that the "**net neutrality** debate is stirring up passions across the spectrum from an order of Benedictine nuns in Kansas to lobbying giants such as AT&T." Roll Call reports that "some supporters of strong net neutrality rules that apply to wireless broadband are taking their case right to the companies" by filing shareholder proposals with **AT&T**, **Verizon** and **Comcast** to maintain open access to the Internet on wireless networks. Shareholder proposals filed by Trillium and other shareholder activists argue that the principle of non-discrimination on the Internet "has been an engine for economic growth, empowering millions of America's small and medium-sized businesses through direct access to the Internet." Open Internet policies on wireless networks have particular importance for minority and economically disadvantaged communities, the proposals state, because people of color access the Internet via cell phones at a much greater rate than their white counterparts, according to recent research. Read the entire Roll Call article: <http://www.rollcall.com/news/-201566-1.html>

### Sustainable Seafood

The global catch of wild fish leveled off more than 20 years ago. 70% of the world's fisheries are being harvested at capacity or are in decline. As a result, public and private sector efforts are underway to improve habitats that sustain fisheries and address the pressures of ecosystem damage and overfishing. Trillium asked **Costco**, a laggard in its industry sector, to develop a seafood program that included: 1) adopting a **sustainable seafood** policy; 2) eliminating at least one threatened species from its store shelves; and 3) working with a third-party expert to strengthen policy objectives.

After sustained pressure from investors and non-profits, management made new commitments to responsible seafood sourcing including a partnership with the World Wildlife Fund (WWF) to help the company with its sustainable seafood procurement. We are pleased with these announcements but will be looking for additional indications of management's commitment to responsible seafood sourcing practices.