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2011 Market Commentary

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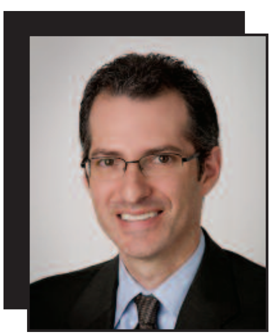
By Steven M. Sheldon, CFA

About SMS Capital Management

SMS provides investment management services to individual investors desiring to preserve and build long-term wealth. As a fee-based firm, SMS has an independent, objective and sound approach to portfolio management. The firm is a Registered Investment Adviser.



About the Author

Steven Sheldon has more than 15 years of professional experience analyzing and managing investments. Prior to founding SMS, Mr. Sheldon worked as a senior member of a corporate principal investments group. Mr. Sheldon has an MBA from Tulane University and a BBA from The University of Texas. In addition, he is a CFA charterholder and a member of both the CFA Institute and the Houston Society of Financial Analysts (HSFA). He is also a Past-President of the MBA Council of Houston.

After all the drama, those that endured the roller coaster stock market ride of 2010 have made pretty decent returns with the S&P 500 advancing 12.8% (or 15% including dividends). As we head into 2011, about the worst thing that can be said about the stock market outlook for next year is that, with few exceptions, everyone is bullish.

Today's environment is starkly different from this time last year when the outlook for 2010 was hotly divided between "Bulls" and "Bears". Now, with more signs that the U.S. economic recovery is on more solid footing, market strategists are optimistic about the outlook for the stock market. Most forecasters estimate S&P 500 total returns for 2011 to be in the 10-20% range. Pretty comforting; except for that fact that Wall Street consensus forecasts are about as reliable as the official snow report provided by the developers that own the ski mountain.

Heading into 2011, investors should remain invested, but take this opportunity to make sure their portfolios have not drifted too far from their intended risk profiles and target allocations. For those looking to add equity exposure, the New Year might offer a better buying opportunity for those that wait for a pullback. **The market's mood can shift as quickly as mountain weather, so don't get too greedy or too complacent in a rising market.**

Can you say Bullish?

The mood on Wall Street and investor sentiment is the quite the opposite of the pervasive pessimism of last summer (height of the "double-dip" recession fears) and is rapidly approaching the optimistic levels of 2007 when the market was peaking. Since extreme optimism (or pessimism) can often precede strong countertrend moves, today's sentiment should be a yellow flag.

Last summer, investors were wallowing in the pessimism surrounding the potential for a "double dip" recession. The stock market had fallen by around 17% and the financial news media was fixating on things like the "Hindenburg Omen" (a technical signal that a market crash is imminent) and Robert Prechter's (a widely followed technical analyst) forecast that a plunge to Dow 1000 was a real possibility. As it turned out, the market was already bottoming, and about to go on an impressive 20% run.

The only divergence in opinion amongst analysts for next year is how strong the gains will be, not whether or not we will actually get them. The basis for

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the "bull case" is compelling. **A fresh dose of government stimulus (including the two-year extension of the Bush tax cuts and a new 2% payroll tax reduction), rising corporate profits (consensus estimates show earnings growth of 13% over 2010), improved fundamentals, strong upward momentum, relative attractiveness as compared to bonds, and the favorable track record of the 3rd year of a president's term in office all support the thesis for higher stock prices in the next twelve months.** The most optimistic bulls even see the Dow and S&P 500 hitting new all-time highs in 2011.

Barring some unforeseen shock that sends the economy back into a recession, it is reasonable to expect corporate earnings to rise again in 2011, but at a much slower pace than 2010's 37% rise off of recessionary levels. That suggests the market can advance as long as the p/e multiple for the SP 500 does not meaningfully contract. The market currently trades at 15x 2010's earning and 13x 2011's earnings forecast**. If S&P earnings rise to a record $95 (consensus estimates) next year, the market could trade up to 1,425 (15 p/e x 95), representing a gain of 13%.**

Bad News Bears

On the other hand, the dwindling camp of bears continue to point to the same sobering reasons why the market is overvalued and susceptible to a big correction from current levels including **lingering high unemployment, continued weakness in the housing market, deflationary pressures(CPI remains at the lowest level in 50 years), record high and growing deficits, fading effects of government stimulus, state governments' austerity and budget cuts, deleveraging by consumers, sovereign risks in Europe, rising interest rates, a potential hard landing in China as the government fights inflation, and stretched valuations.**

Not to mention, if everything was so great, why would the Federal Reserve and the government feel so compelled to continue with their aggressive monetary and fiscal policies?

A good argument can be made that U.S. corporations have already squeezed out all the costs they can and margins will contract from current record levels, hurting earnings in the process. Furthermore, the challenges facing the U.S. economy are more supportive of lower p/e multiples rather than the "15x" that analysts contemplate when making forward looking forecasts. Thus, even if S&P 500 earnings do grow to $95 next year, the market may remain flat or down, if the p/e multiple contracts to 13x or below. And, if earnings fall short of analysts' expectations, an even lower valuation is plausible.

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Portfolio Positioning

Next year might very well turn out to be another solid year for the stock market, marking three straight years of gains following 2008's plummet. **I see S&P 500 potentially trading as low as 1,100 and as high as 1,400 next year, representing almost equal upside and downside cases: 13% downside and 11% upside from current levels.**

Given the nearly equal upside and downside cases, investors should look to reallocate back to their long term allocation targets, but rely more on "actively managed" and "value" oriented fund managers for equity exposure at this stage rather than pure index funds. Also, keeping a portion of equity exposure in funds utilizing "alternative" and "absolute-return" strategies will help limit volatility and secure returns if the market treads sideways or moves back down next year.

Also, the resent sell-off in the fixed income market has created some opportunities for more conservative investors (particularly those in high tax brackets) and those that have been looking for an opportunity to get into fixed income. The municipal bond market was hit especially hard since November and now offers a more attractive risk/return profile. Fears of widespread defaults for states and municipalities may be overblown. Investors can now earn substantially better tax-adjusted returns than in U.S. Treasuries or investment grade corporate in the municipal market. Investors can leg into high quality municipal bond funds throughout the year limiting downside should rates rise even further (pushing prices lower) than today's levels.

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