



## Market Analysis, Research & Education

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# The Top 10 Surprises of 2010 in the Financial Markets

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Investors had plenty of unforeseen global events to digest throughout 2010, including sovereign debt crises, unexplained market declines (i.e., “flash crash”), military transgressions, and election year outcomes, to name a few. The following is the MARE group’s list (in no particular order of priority) of the most surprising developments in the financial markets during the past year.

**1** *Goldilocks backdrop for financial assets*  
It was a year of extreme scenarios filling the headlines. At times, fears of a looming inflationary threat from heavy monetary stimulus and high government deficits dominated the airwaves; at other times, fears of deflation amid economic stagnation and sovereign debt crises in Europe got the upper hand. But in 2010, the inflation-deflation battle roughly cancelled itself out. The environment was just “hot” enough to keep the global economic recovery on track, with surprisingly strong growth from Germany, Brazil, Turkey and others. However, it was just “cold” enough to keep inflation low and falling and policymakers worried, as the Federal Reserve (Fed) stepped on the accelerator in November with another round of quantitative-easing bond purchases aimed at further boosting the below-trend U.S. economy. The results: incremental economic growth, supportive monetary policies, corporate profit gains, and all with very little inflation. That mix was just right to boost the returns for almost all major types of stocks, bonds and other assets, making it hard to find any asset categories that lost money in 2010. In fact, the only real losing strategy during the past year was not being invested.

**2** *European debt crisis did not derail global recovery*  
One major question entering 2010 was when the high and rising levels of sovereign debt in many developed economies would become a front-burner concern for the financial markets.

That occurred in the spring, when Greek government bonds spiked above 13%, sending the euro plummeting and tremors across global financial markets.<sup>i</sup> Things stabilized after Greece was bailed out and Europe created a nearly \$1 trillion rescue fund for future problems, but a few months later Ireland became the next victim and a new round of turmoil sowed doubts about the future structure of the European currency union. Despite the fact the euro is the world’s second most-important currency and the Euro-zone’s economy accounts for 15% of global output, the region’s sovereign debt turmoil did not knock the global economic recovery off its tracks. European sovereign debt issues may well continue to smolder and provide an ongoing climate of uncertainty for financial markets, but the good news in 2010 was that the global economy showed it could survive Euro-zone troubles amid economic strength in emerging markets and other areas.

**3** *Interest rates did not rise*  
To many investors going into 2010, it appeared interest rates had only one direction to move—up. The Fed had pinned its short-term borrowing rate near zero in 2009, and long-term U.S. Treasury yields had recovered from historic lows, with the 10-year yield beginning 2010 at 3.8%. By April 2010, the 10-year yield was above 4% for the first time since 2008 as the U.S. economy picked up steam. Then the Greek debt crisis hit the financial markets, the global economy downshifted amid whispers of a possible double-dip recession, the Fed announced its Treasury-purchase program, and yields ended up falling back to 2.4%. They then reversed course and rose above 3% through mid-December, causing bond prices to fall late in the year.<sup>ii</sup> But overall, it was a decent year for bond investors, with modest gains across most high-quality bond categories, and even larger returns to riskier areas, such as corporate high yield and emerging-market debt.<sup>iii</sup>

4 *U.S. stocks remained unloved by mutual-fund investors*

With U.S. stocks up more than 90% from their March 2009 low, historical behavior patterns suggested investors would be flocking to stocks in droves.<sup>iv</sup> However, through October, mutual-fund investors pulled a net \$64 billion out of U.S. stock funds during 2010, while continuing to plow money into bond funds instead. Though bond fund inflows slowed from their record pace earlier in the year, the year-to-date \$223 billion inflow through October was still impressive. There were, however, signs of a sentiment shift late in the year, as the stock rally continued, interest rates moved up, and bond fund flows dried up.<sup>v</sup> Looking to 2011, there are good reasons interest in bonds may remain high, including an aging population that is increasingly looking for income and has a more conservative investment profile. However, with investor interest in stocks still tepid and U.S. stock valuations at reasonable levels, perhaps stocks may garner more attention from fund investors in 2011.

***The 2010 results: incremental economic growth, supportive monetary policies, corporate profit gains, and all with very little inflation. That mix was just right to boost the returns for almost all major asset categories, with few areas that lost money.***

5 *Two-speed, imbalanced world*

It is widely acknowledged that developing economies, such as India and China, have grown much faster than developed nations and are expected to do so for some time into the future. In a world full of contrasts and imbalances, that was just the beginning. The Euro-zone dichotomy included a periphery where Spain's unemployment rose above 20%, and Ireland and Greece slumped back into recession, while Germany's economy rode blockbuster export growth to a near-two-decade low in unemployment.<sup>vi</sup> Commodity markets flourished, with agricultural commodities and copper returning to mid-2008 record levels, while core inflation rates in the U.S. hit 50-year lows. Within the U.S. economy, the residential housing market languished as sales slumped and foreclosures bulged, but corporate capital spending was brisk. Unemployment remained stubbornly high near 10%, but consumer spending picked up steam throughout the year.<sup>vii</sup> Corporations borrowed at record low rates, but more than 150

banks failed in 2010, and getting a residential mortgage without a high credit score was a futile effort.<sup>viii</sup>

6 *Gold's luster shined even more brightly*

Given the favorable backdrop for gold, perhaps it is not surprising that it once again climbed to record highs (above \$1400 per ounce) and was one of the best-performing asset categories in 2010.<sup>ix</sup> High levels of global liquidity pumped out by the world's monetary authorities gave inflation bugs plenty of reason to purchase gold, while scary government debt dynamics and the Euro-zone's somewhat erratic response to the its sovereign crisis sowed doubts about global financial stability. Throw in a North Korean attack on its South Korean neighbor, and there was something for everyone to like in gold as a safe haven against potential financial and geopolitical systemic risks. The surprise? How about the consistency of gold's ascent. Despite rising 55% during the past two years, it hasn't endured a major correction. When U.S. stocks swooned 18% during the summer amid the Greek debt crisis and concerns about an economic slowdown, gold rose during the same period.<sup>x</sup> In a still highly correlated world, gold proved its value as a portfolio diversifier.

7 *Corporate strength hit new levels*

While not a startling development that corporate business did well in 2010, the extent to which it thrived in a relatively unimpressive economic environment was unexpected. Corporate earnings reached an all-time high by the middle of the year, recovering to a previous peak far faster than most sectors of the U.S. economy. Strong cash flows helped propel corporate cash positions to their highest level (relative to total assets) in 50 years, leaving nearly \$2 trillion of available funds on their balance sheets.<sup>x</sup> Corporate bond issuance occurred at a record pace, as a number of major companies were able to borrow at unbelievably low interest rates, and corporate bond investors took comfort in the solid balance sheets and creditworthy profiles. Stocks benefited as price-to-earnings valuations remained moderate, and merger and acquisition activity picked up, with hopes that more money will be deployed toward dividend payments and share buybacks in 2011. While workers hope businesses will use more of that cash in 2011 to hire back employees and bring the unemployment rate down, investors benefited from a healthy corporate sector in 2010.

- 8 *Flicker of hope in Washington?*  
After years of both political parties being at odds over spending and tax priorities, and with few politicians speaking openly about concrete plans for medium-term fiscal stability, the end of 2010 provided a faint surprise. The White House and Congress ironed out a compromise that extends Bush-era personal income tax rates, provides a payroll tax break, and extends unemployment insurance, which collectively will result in more stimulus than expected in 2011. While the agreement increases the deficit, separately the White-House-appointed deficit commission drew more support and wider attention than expected with its plan to achieve fiscal sustainability. Although the commission's plan will not become legislation, it may have moved the fiscal debate closer toward tackling not only thorny issues such as Social Security, but also much-needed tax reform that could be the best low-cost option to increase productivity in the U.S. economy. Lastly, the Obama Administration reached a trade pact with South Korea, capping a late-year focus on exports and business. With few investors expecting much positive news out of Washington, any subtle shift toward pro-growth and fiscally sustainable policies would indeed be a pleasant surprise for 2011.

***Most asset categories registered solid returns in single-digit or modest double-digit levels, with few having spectacular years or terrible ones. In fact, the difference between the best-performing asset category in 2010 and the worst-performing was less than half as large as the historical average, underscoring the unusual cluster of averageness.***

- 9 *Gloves come off in currency debate*  
The sparks of global currency tensions really got going in 2010 after the Fed signaled its new round of quantitative easing, which some countries argued was an effort to devalue the U.S. currency by flooding the world with cheap dollars. Countries

from Japan to South Korea to Brazil intervened in the foreign exchange markets to try to keep their currency values from rising, with the Brazilian Finance Minister famously complaining that a global “currency war” had begun. Hyperbole aside, the global exchange-rate system that affects trade and capital flows is currently facing an anxious and inherently unstable proposition—no major country in the world wants its currency to strengthen, as most nations look to maximize export growth at a time when global trade is still struggling to get back to pre-recession levels. In 2011, China likely holds the near-term key to not only deal with rising inflation but also diffusing global tension if it moves more quickly to revalue its currency. However, signs out of Beijing were mixed on this front in 2010. For U.S. investors, the good news was a decline in the U.S. dollar boosted returns to foreign stock holdings, while foreign currency exposure provided a less correlated asset that boosted portfolio diversification.

- 10 *Ho hum, a solidly average year*  
After a disastrous 2008, an astounding rebound in 2009, and an uncertain outlook in 2010, getting back to a dull, average kind of year in the financial markets might have appeared to be a pipe dream. However, average is what we got. The returns to U.S. stocks were right around historical averages, as were the returns to investment-grade bonds.<sup>xi</sup> Most asset categories registered solid returns in single-digit or modest double-digit levels, with few having spectacular years or terrible ones.<sup>xii</sup> In fact, the difference between the best-performing asset category in 2010 and the worst-performing was less than half as large as the historical average, underscoring the unusual cluster of averageness.<sup>xiii</sup> Further, despite a year that included plenty of macroeconomic uncertainty and a “flash crash” in the stock market, even volatility was fairly average. The standard deviations of both U.S. stock and bond returns were near their long-term averages.<sup>xiii</sup> While investor angst might remain high amid many continued uncertainties in the coming year, 2010 reaffirmed that you can't predict market behavior by looking at the headlines. ■

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*Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk. Diversification cannot ensure a profit or protect against loss.*

**Past performance is no guarantee of future results.**

- [i] Greece's 10-year bond yield hit 13.17% on 5/7/10. Source: Financial Times, Haver Analytics, FMRCo. (MARE) as of 12/13/10.
- [ii] On April 5, 2010, the 10-year Treasury yield hit 4.01%, then fell to 2.41% on 10/6/10. On Dec 2, 2010, the 10-year Treasury backed up to 3.01%. Source: Federal Reserve Board, Haver Analytics, FMRCo. (MARE) as of 12/13/10.
- [iii] All references to asset classes in the article and their respective U.S. dollar returns (%) for 2010 are as follows (unless otherwise noted): Large Caps – S&P 500 Index (13.4%); Small Caps – Russell 2000 Index (24.9%); Developed Country Stocks – MSCI EAFE Index (7.4%); Emerging Markets – MSCI Emerging Markets Index (16.2%); High Yield – Bank of America Merrill Lynch U.S. High Yield Master II Index (14.3%); Investment-Grade Bonds – Barclays Capital U.S. Aggregate Bond Index (6.2%); Real Estate – NAREIT Equity-Only Index (22.7%); Commodities – S&P GSCI Commodity Index (5.7%); Gold – London Gold Bullion, PM Fix US\$/Troy Oz. (28.6%). Source: FactSet, Wall Street Journal, FMRCo. (MARE) as of 12/13/10.
- [iv] U.S. Stocks represented by the S&P 500 Index, which appreciated 90.3% from 3/9/09 to 12/13/10. Source: FactSet, FMRCo. (MARE) as of 12/13/10.
- [v] Year-to-date net flows for U.S. equity and bond funds were -\$64 billion and \$223 billion, respectively, through October 2010. Weekly net bond fund flows turned negative the last two weeks of November 2010. Source: Investment Company Institute, Haver Analytics, FMRCo. (MARE) as of 12/13/10.
- [vi] Spain's unemployment rate was 20.7% in Oct. 2010, while Germany's was 7.5% in Nov. 2010. Source: Statistical Office of the European Communities, Haver Analytics, FMRCo. (MARE) as of 11/30/10.
- [vii] The High-Grade Copper COMEX spot price (\$/lb) reached an all-time high of \$4.20 on 12/13/10. The S&P 500 GSCI Agricultural Commodities Index stood at 486.22 on 12/13/10, very near its high of 499.25 set on 3/12/08. The U.S. core inflation rate was 0.59% year-over-year, an all-time low. The S&P/Case-Shiller Home Price Index of 20 metro areas is down 0.05% from Jan. 2010 to Sep. 2010. The number of new consumers with new foreclosures was 457,000 in Q3 2010. Gross private domestic investment grew 22.4% year-over-year in Q3 2010. The unemployment rate in Nov. 2010 was 9.8%. Personal consumption expenditures rose from \$10.1 trillion in Q4 2009 to \$10.4 trillion in Q3 2010. Source: Standard and Poor's, Bureau of Labor Statistics, Bureau of Economic Analysis, Haver Analytics, FMRCo. (MARE) as of 12/13/10.
- [viii] As of 12/10/10, the Federal Deposit Insurance Corporation stated that 151 institutions had failed or been assisted. Source: Federal Deposit Insurance Corporation, Haver Analytics, FMRCo. (MARE) as of 12/10/10.
- [ix] The S&P 500 fell 15.6% from 4/23/10 to 7/2/10, while gold appreciated by 6%. Source: Standard and Poor's, Wall Street Journal, Haver Analytics, FMRCo. (MARE) as of 12/13/10.
- [x] Corporate profits after taxes with inventory valuation and capital consumption adjustments stood at an all-time high of \$1.2 trillion in Q3 2010. Corporate liquid assets of non-financial corporations stood at \$1.93 trillion as of Q3 2010, which represented 7.4% of total assets. Source: Bureau of Economic Analysis, Federal Reserve Board, FMRCo. (MARE) as of 9/30/10.
- [xi] The S&P 500's calendar year average from 1926 through Oct. 2010 is 11.8%. Investment grade bond's calendar year average from 1926 through Oct. 2010 is 5.7%. Investment-grade bonds represented by Barclay's Capital Aggregate Bond Index from 1976-2010: from 1926-1975 bonds are represented by a weighted composite of the IA Long-term Corporate Bond Index (34%) and the IA Intermediate-term Government Bond Index (66%). Source: Ibbotson Associates, FMRCo. (MARE) as of 10/31/10.
- [xii] The range of returns for the major asset classes listed in footnote #3 above (excl. gold) was 19.2 on a year-to-date basis through Dec.13, 2010, compared to a historical average range of 51.5 dating back to 1988. Source: Ibbotson Associates, FMRCo. (MARE) as of 12/13/10.
- [xiii] The S&P 500's standard deviation from 1926 through Nov. 2010 is 21.4%, while year-to-date through Nov. 2010 it stood at 21.3%. Investment-grade bonds historical standard deviation is 4.7%, while year-to-date through Nov. 2010 it was 2.6%. Investment-grade bonds represented by Barclay's Capital Aggregate Bond Index from 1976-2010: from 1926-1975 bonds are represented by a weighted composite of the IA Long-term Corporate Bond Index (34%) and the IA Intermediate-term Government Bond Index (66%). Source: Ibbotson Associates, FMRCo. (MARE) as of 10/31/10.

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