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Sun is Shining on Investors as 2010 Draws to a Close

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The sun is shining on investors as 2010 draws to a close. The economy has shown signs of reaccelerating from the summer soft spot, the stock market has made new two-year highs, as measured by the S&P 500 (returning to the level that preceded the September 2008 failure of Lehman Brothers), and the President signed into law a bill that extends all of the Bush tax cuts for two years, cuts payroll taxes, and expands jobless benefits.

The end of 2010 also seems to be setting the stage for the return of diversification. In 2008 and 2009, most markets moved together as the outlook for all financial assets was tightly linked to the global financial crisis and then to the recovery. During 2010, glimmers of the impending return of diversification became evident as markets began to behave more independently of each other. In May and June, as stocks and commodities asset classes fell, bonds steadily rose in value. And, inversely, in November and December, as stocks and commodities asset classes surged, bonds fell. A key potential benefit of having the investments in your portfolio behave differently is that it should serve to mute volatility, which is especially valuable when taking distributions from a portfolio. The return of the effectiveness of this important investment risk management tool is a welcome gift as investors look toward 2011.

However, the horizon for investors is not brightening everywhere. One area with a cloudy outlook is municipal bonds. The fiscal challenges facing U.S. states are serious and need to continue to be addressed in the coming years. However, we do not expect a stormy environment akin to the solvency troubles that plagued Europe in 2010. The state debt issues are different than those troubles in Europe in two main regards:

- First, the magnitude of the problem facing some European nations is much greater. For example, the budget deficit-to-GDP ratio for some of the most troubled states, such as California, New York, and Florida, average about 1%, while European nations like Greece, Portugal, Ireland, and Spain average about 10%. Additionally, the total debt-to-GDP ratio for these same states average about 20% when including the states' unfunded pension liabilities while those of the European nations are much higher at around 100%.
- Second, the ownership of the respective bond markets is very different. Banks in the U.S. do not own much domestic municipal government debt while European banks own a lot of European government debt, which has magnified the problems overseas relative to those of the states.

No stormy skies or bright sunshine for 2011, ***we see a more middle of the road forecast – "Mostly Sunny with a Mixture of Clouds"***. Recent years have seen extremes one way or the other and we see a 2011 that offers investors modest gains for stocks, low-to-mid single-digit gains for bonds, and an economy in the United States that muddles along at about a 2.5 to 3% pace. If you would like to discuss our **2011 Outlook** in more detail, I encourage you to give me a call.

Happy New Years!

Sincerely,

Preston

J. Preston Byers CPA CFP®
President

pbyers@clearbridgewealth.com

7000 Central Parkway Suite 1760 | Atlanta, GA 30328 | 770-350-9605

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There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

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